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Investment Perspectives

Fixed Income: Addressing the Risk-Adjusted Versus Absolute Return Question

The discussion takes on added importance with the inflection point of a U.S. Federal Reserve rate cut.

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With the September 18 rate cut of 50 basis points by the U.S. Federal Reserve (Fed), we can officially declare the end of Act I for the movement of the U.S. Treasury yield curve, and history has largely repeated itself. But will the easing cycles of years past be a reliable predictor of yield curve change in Act II?

Part of that answer will depend on the economic cycle and the length and depth of a U.S. recession, if one is entered. But there is also an underlying regime characterized by small term premium and flat yield curves, and consideration of these factors will be important in decision-making for risk-adjusted versus absolute returns, as well as strategic and tactical asset allocation.

The Market Impact of Fed Rate Cuts

We've previously shared Figure 1, regarding the movement of Treasury yields in the six months prior to, and six months after, the first rate cut of an easing cycle; the change in yields are average changes observed over the last four easing cycles. We've overlaid the yield change of Treasury yields for the six months ended September 18, 2024, and as we can observe, the pattern has remained the same.

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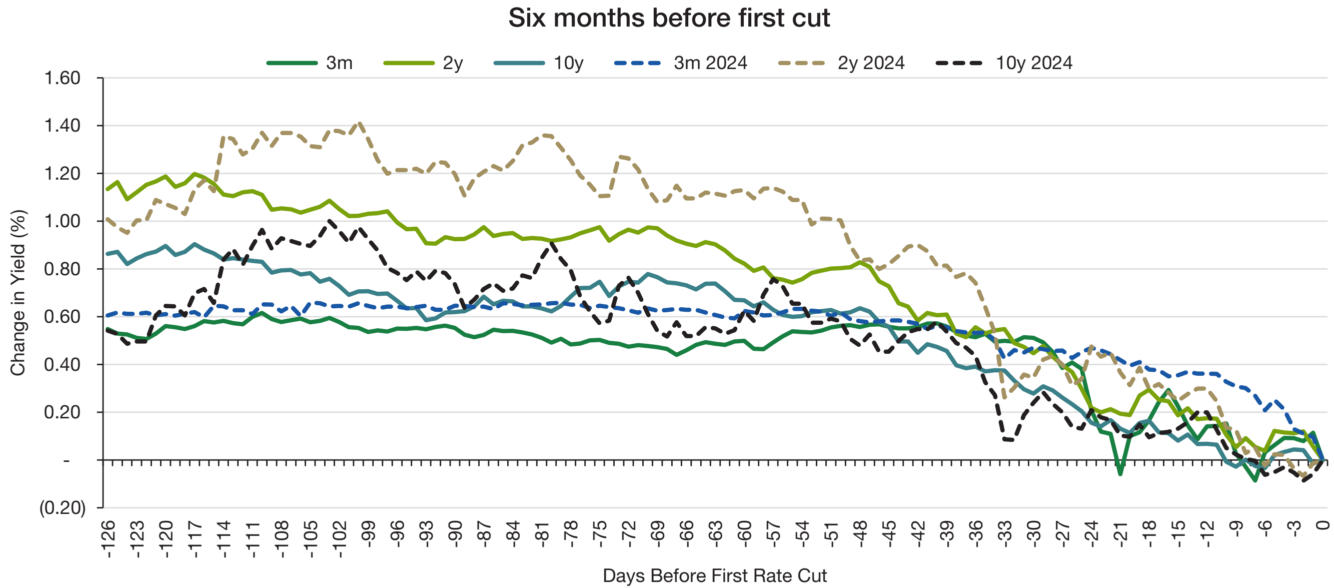
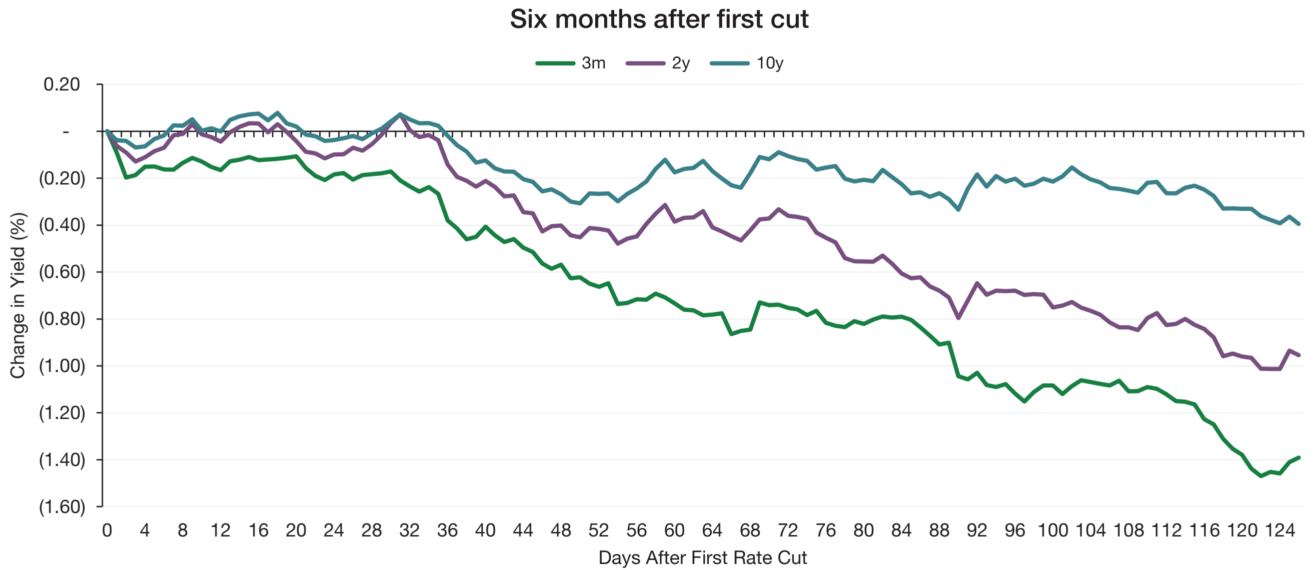
Figure 1. Tracking the Path of U.S. Treasury Yields Before, and After, Initial Fed Rate Cuts





Source: Bloomberg. Chart depicts average path of yields for U.S. Treasury securities of stated maturities six months before, and six months after, the first cut in the fed funds rate in tightening cycles that began in 1995, 2001, 2007, 2019, and in the six months preceding the Fed cut on September 18, 2024.

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Act II: Steeper Like Before

As mentioned, on average, there has been a noticeable steepening between two- and 10-year Treasuries in the six months following the first rate cut of an easing cycle, and there certainly exists a scenario where a similar outcome will be experienced in 2024–25. The interpretation of the level of the 10-year Treasury yield can vary, but from a historical perspective, one of the most common and logical interpretations is that the risk-free rate of the 10-year Treasury investment should approximate (and for which the investor should be compensated) the level of real (inflation-adjusted) economic growth—plus some expectation of inflation and some term premium to represent uncertainty.

When the Fed is implementing an aggressive easing policy, a steeper curve should be expected. First, the two-year Treasury is a representation of short-term rates and more correlated to the direction and level of the fed funds rate, which creates downward pressure on two-year yields; and second, the easing of financial conditions creates an intermediate anticipation of potential higher real growth, higher inflation expectations, and greater uncertainty (term premium) therein, which causes the upward pressure on 10-year Treasury yields.

So, what would it take for the Fed to implement an aggressive easing policy in 2024–25? We feel that would be a recession with the condition that inflation has moderated, and the Fed and the markets have a high conviction that the central bank's mandate of "stable prices" has been or will imminently be satisfied. Looking at the average yield curve slope from two- to 10-year Treasuries for the last four recessions (Figure 2), we can see that an upward slope is reliable, and over the four recessions, the slope averaged +108 bps.

Figure 2. Tracking the Slope of the Yield Curve in Past U.S. Recessions

Recession	Average 2s/10s Slope (bps)
1990-91	82
2001	134
2007-09	179
2020	37

Source: Bloomberg. Bps = basis points; one basis point is equal to one one-hundredth of a percentage point. For illustrative purposes only.

Act II: Different from the Past

On October 11, 2001, Fed Chair Alan Greenspan gave remarks on "Transparency in monetary policy" at a conference in St. Louis, and there are two excerpts from that speech which we believe are relevant for this writing. The first, citing a decades-old debate on market uncertainty and its impact on short-term debt markets: "As markets, experience, and the magnitude of outstanding financial instruments changed, the dead-weight loss created by such uncertainty became increasingly evident, as did the value of transparency."

We previously mentioned one interpretation of the level of the 10-year Treasury yield to support yield curve slope movement during an easing cycle. Another interpretation, according to the Federal Reserve Bank of New York, is that "yields on Treasury securities are composed of two components: expectations of the future path of short-term Treasury yields and the Treasury term premium. The term premium is defined as the compensation that investors require for bearing the risk that interest rates may change over the life of the bond."

Figure 3 shows the estimated term premium for the 10-year Treasury since mid-1961, and it is observable that term premium has been much lower as of late. It is largely an arbitrary date since it's difficult to exactly pinpoint the date of a regime change, but using October 11, 2001, as the point of demarcation: the average term premium for the 10-year Treasury after said date is -9 bps while before the date, the average is +187 bps. Was there indeed a regime shift? Perhaps a definitive answer can't be given until a few more economic cycles are experienced, but simply asked via hyperbole: Why should an investor be compensated for changes in interest rates when the Fed is committed to full transparency of monetary policy and the potential future path of short-term Treasury yields?

Figure 3. Term Premium Has Been Declining

Estimated term premium on 10-year U.S. Treasury debt, July 1962–August 2024

Source: Bloomberg and Lord Abbett. Data as of August 31, 2024. Term premium is defined as the compensation that investors require for bearing the risk that interest rates may change over the life of a bond. Term premia are estimated, most often from financial and macroeconomic variables.

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Case in point, the most recent "dot-plot" projection[1] revealed at the September 18, 2024, meeting of the Federal Open Market Committee, the Fed's policy-setting arm, suggests the FOMC voting members believe the long-run neutral fed funds rate is in a range between 2.375% and 3.75%, and the median observation is 2.875%. This brings us to the second of Greenspan's remarks on transparency from the 2001 speech cited earlier: "By price stability, however, I do not refer to a single number as measured by a particular price index. In fact, it has become increasingly difficult to pin down the notion of what constitutes a stable general price level."

Since Chairman Greenspan's remarks, the world has changed, and we now have an average inflation target of 2%, but this is a target over the long term, and we feel it's reasonable that we will find periods when price stability can be found at higher (or lower) rates of inflation, while achieving the dual mandate (price stability, as mentioned earlier, and full employment). And currently, the unique status of the U.S. housing market, defined by an extreme supply/demand imbalance, could cause shelter inflation, and inflation measures in general, to remain elevated for an extended period.

But, in this scenario where the Fed can provide policy accommodation to engineer a soft landing, while remaining confident in having achieved price stability (and not a predetermined rate of inflation), then the yield curve can represent the market's interpretation of the neutral fed funds rate across maturities with little term premium. In other words, given current expectations of the neutral rate, the forward six-month experience of Treasury yields should be a decline with a parallel movement across maturities, including two- and 10-year.

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Act II: The One No One Sees Coming

Since we've covered yield curve movements of steepening and parallel shift, we should mention a flattening or reinversion of the yield curve for completeness. The most likely conditions to drive this movement would include:

- Reacceleration of inflation
- Fed prioritizing the battle against inflation
- Continued restrictive monetary policy
- Expectation or realization of declining labor and economic fundamentals, and a U.S. recession

Return Is in the Eye of the Beholder

So, on to the question of absolute or risk-adjusted return cited at the beginning of the piece. In Figure 3, we display the characteristics of short- and intermediate-term Bloomberg U.S. Government/Credit indexes, including yield and duration. The standard deviation of returns for these indexes is also shown for the last one, five, and 10 years. Let's consider the potential for outcomes in the above scenarios through the lens of interest rates and credit to address the risk-adjusted versus absolute return question.

Figure 3. At the Start of a New Rate-Cut Cycle, Some Key Comparisons for Short- and Intermediate-Term Bonds

As of September 18, 2024	Bloomberg 1-3 Year Government/ Credit Index	Bloomberg 5-10 Year Government/ Credit Index
Yield (%)	3.84	4.05
Duration (years)	1.9	6.2
Annualized Standard Deviation of Returns (%) as of August 31, 2024		
1-year	1.9	8.3
5-year	1.9	6.8
10-year	1.5	5.5

Source: Bloomberg.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Standard deviation is a statistic that measures the dispersion of a data set relative to its mean. The higher the standard deviation, the further the observed data are from the mean.

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To begin, given the relative flatness of the yield curve currently and the subsequent similarity in current yield for the provided indexes, a short-duration strategy will more often than not provide a better risk-adjusted experience. As shown, the standard deviation of historical returns for the intermediate government/credit index is approximately four times that of the shorter-duration counterpart.

In a curve-steepening scenario, an exposure to credit risk will likely benefit over a longer horizon, as an easing cycle creates expectations of an economic upturn/recovery and a pricing of risk on expected stronger fundamentals. A shorter-duration strategy will absolutely have the better risk-adjusted return given the steepening environment, but the absolute return question is more difficult to answer. This will depend upon the type of yield curve steepening, and how each maturity of the yield curve changes in level.

In a scenario of a flat yield curve that is moving in parallel fashion, a shorter-duration strategy will again have a better risk-adjusted return given starting yields. The decline in Treasury yields that would be required to drive such a higher return in an intermediate strategy to offset the much higher historical return volatility is logically unattainable. But, in an absolute return sense, the power of duration in a declining yield environment makes intermediate duration an obvious allocation, in our view; and in this environment, defined by a soft landing and a Fed gradually moving toward a neutral rate, credit risk will offer advantages as well.

And last, in the scenario that no one sees coming, both risk-adjusted and absolute returns being more favorable in an intermediate-duration strategy is a reasonable outcome, especially with a strategy that is higher in credit quality.

So, strategic and tactical decisions abound over these next six months, and allocation choices, of course, depend upon the eye of the beholder. But we think history has provided us with some useful insights to help inform those choices.

[1]Economic projections are collected from each member of the Fed's Board of Governors and each Federal Reserve Bank president four times a year, in connection with the Federal Open Market Committee's (FOMC's) meetings in March, June, September, and December. The charts and tables associated with those projections are released shortly following the end of an FOMC meeting.

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Glossary & Index Definitions

Absolute return measures an investment's overall return, regardless of the market conditions that may or may not have affected it. A **risk-adjusted return** is a calculation of the profit or potential profit from an investment that considers the degree of risk that must be accepted to achieve it. The risk is measured in comparison to that of a virtually risk-free investment—usually U.S. Treasuries.

A **basis point** is one one-hundredth of a percentage point.

The **Federal Reserve System** (Fed) is the central bank of the United States and is governed by the Federal Reserve Board. The **Federal Open Market Committee (FOMC)**, the policy-setting arm of the U.S. Federal Reserve, issues projections of the rate of U.S. economic growth at the conclusion of its meetings in March, June, September, and December of each year.

The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

The **neutral rate of interest**, also known as **r-star**, is the real short-term interest rate expected to prevail when an economy is at full strength and inflation is stable.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Term premium is defined as the compensation that investors require for bearing the risk that interest rates may change over the life of a bond. Term premia are estimated, most often from financial and macroeconomic variables.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. **Yield-to-worst** refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

The **Bloomberg U.S. Government/Credit Bond Index** is an unmanaged index that is designed to represent a combination of the Government Bond Index and the Corporate Bond Index and includes U.S. government Treasury and agency securities, corporate bonds, and Yankee bonds. The Bloomberg U.S. 1-3 Year Government/Credit Bond Index and Bloomberg U.S. 5-10 Year Government/Credit Bond Index are maturity-specific subsets of the Bloomberg U.S. Government/Credit Bond Index.

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