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USING REAL YIELDS TO POSITION FIXED INCOME PORTFOLIOS

Guy LeBas | Chief Fixed Income Strategist

In the fixed-income markets, we typically talk in terms of "nominal" interest rates. Despite this focus, real yields are a better tool for evaluating future returns. Janney ISG has built a model of forward return potential. While no model can predict the future with certainty, with real yields at current levels, the modeled 12-month forward bond markets returns are showing one of the strongest readings in the last decade.

News articles, financial media networks, and even fixed-income traders rely on "nominal" yields in discussing the bond markets. Nominal rates represent the yield promised by an investment instrument, like a bond or savings account, without factoring in the impact of changing purchasing power over time. Nominal interest rates serve as a fundamental metric for evaluating the attractiveness of investment opportunities, offering investors a baseline figure to assess potential returns. However, to grasp an investment's true profitability amidst fluctuating inflationary pressures, they require more context. Real yields can provide some of that context.

Real yields in the bond market represent an alternative metric to discern the purchasing power and after-inflation return on fixed-income securities. Essentially, real yields measure the return on an investment after factoring out the corrosive effects of inflation. By way of example, consider a 10-year Treasury note with a 5% interest rate. If inflation measures 3% over the horizon of that note, the real yield of the hypothetical note is 2%. Real yields, by negating the inflationary impact, arguably offer a better long-term portrayal of an investment's profitability.

The significance of real yields resides in their capacity to better estimate the value proposition of a fixed-income instrument. Elevated real yields signify strong return potential, while depressed real yields denote a less favorable potential. The challenge with real yields is that they are difficult to estimate in advance. In our above example, we used a known 3% inflation rate, but forward inflation (as the 2021-2022 episode proves) is hard to estimate. Fortunately, the markets have a solution for estimating future inflation: TIPS.

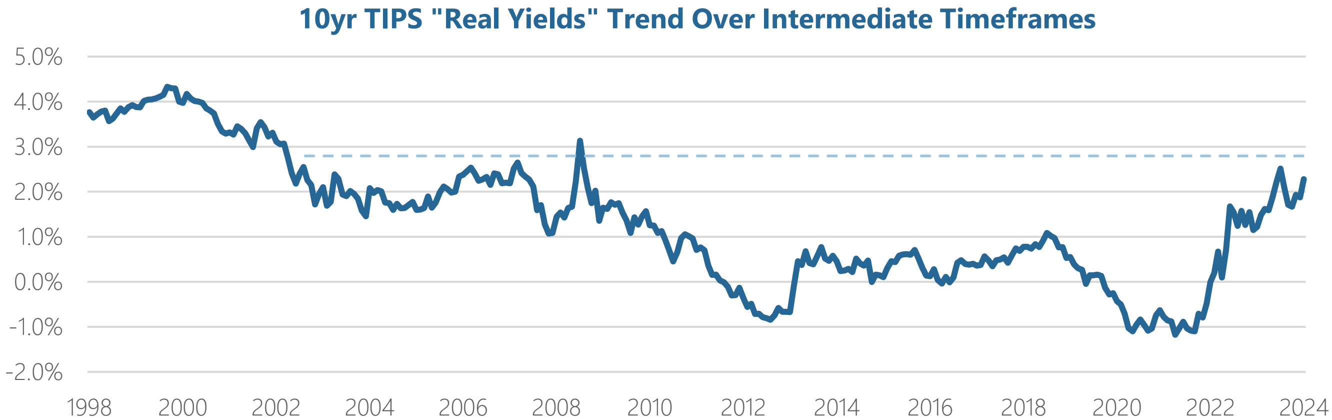
TIPS are issued by the U.S. Treasury
- Maturities of 5, 10, or 30 years
- Fixed coupon until maturity
- Principal value changes with inflation

TIPS protect against inflation
- If inflation increases, the principal amount of TIPS increases
- This increase helps preserve the purchasing power of investment

TIPS generate a "real yield" excluding inflation risk
- Difference between TIPS & coupon Treasury is expected inflation
- Real yield is a better measure of expected bond market returns

We can use these "real yields" to identify entry points for adding to fixed income allocations

Treasury Inflation-Protected Securities (TIPS) are government bonds designed to shield investors from the erosive effects of inflation. Unlike traditional bonds, the principal value of TIPS adjusts based on changes in the Consumer Price Index (CPI), ensuring that investors receive a return that maintains pace with inflation. Since coupon Treasuries do not adjust for inflation, but TIPS do, we can use the yield on a coupon Treasury and the yield on a TIPS with the same maturity to get an unbiased estimate of future inflation. That estimate is far from perfect and is subject to bias in extreme market conditions, but in the long run it is a reasonable proxy for inflation expectations.



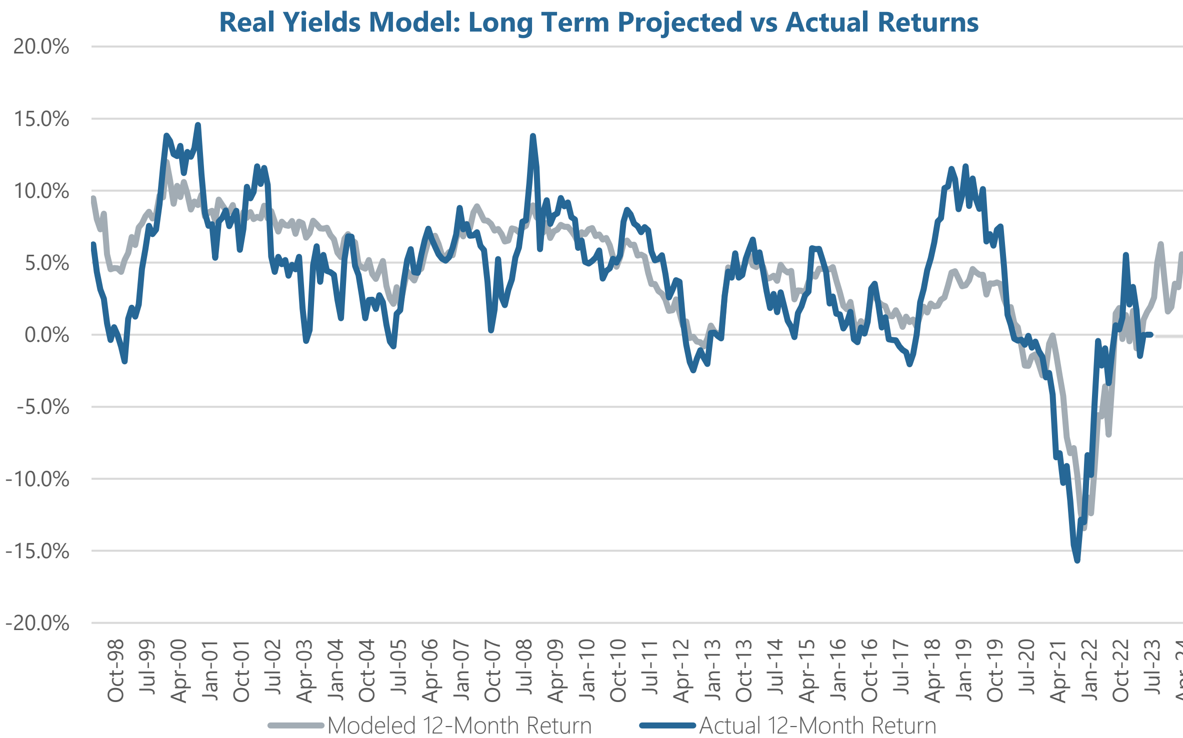
Source: Janney ISG; Bloomberg

Meanwhile, the real yield on a TIPS is a tremendously useful tool for timing allocations for the fixed-income markets. Nominal yields often move more rapidly, but real yields tend to trend over intermediate timeframes. A great example is the bond markets selloff in the fall of 2023, in which 10-year nominal yields spanned a 1.0% range while 10-year real yields spanned a 0.6% range. Unlike nominal yields, which are subject to swings in short-term economic data, real yields tend to be more a function of longer-term supply and demand. Perhaps counteractively, the key insight we take from TIPS is that using high real yields as an entry point to adding to fixed-income portfolios had been a persistently profitable investing strategy. Conversely, reducing fixed-income portfolios when real yields are low has helped limit drawdowns. Today, real yields are relatively high, making it a good time to add to fixed income and/or to extend portfolio durations on the margin.

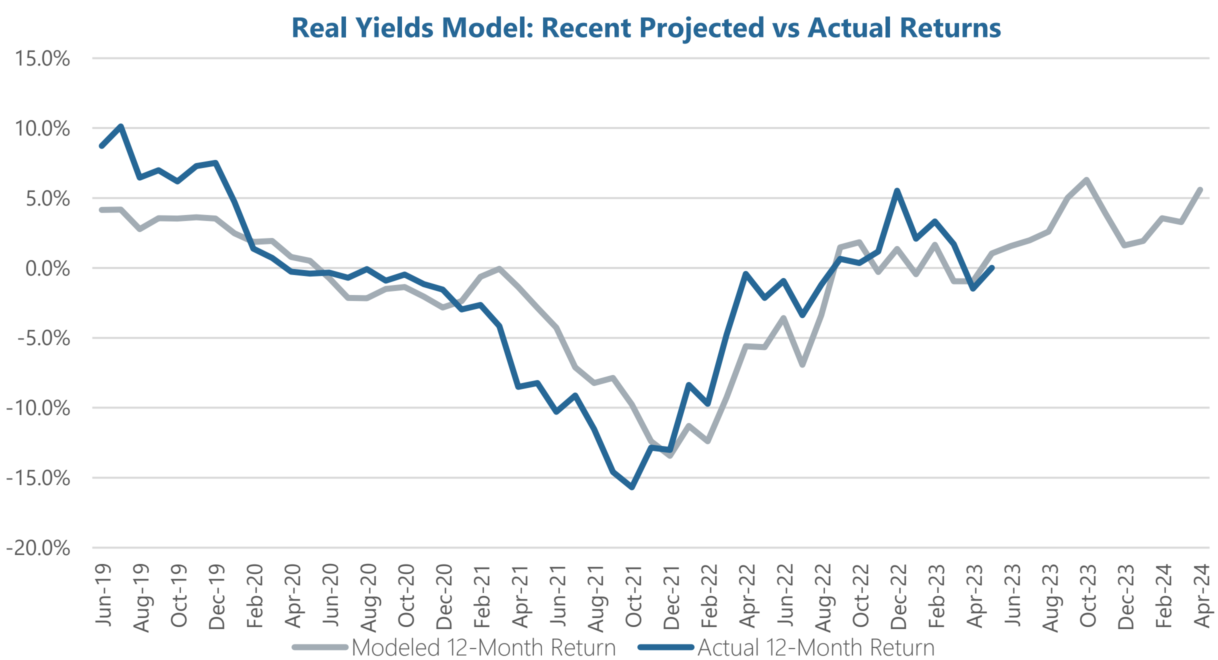
Many factors affect forward fixed-income returns, from predictable economic developments, to unexpected ones, as well as changes in credit conditions. In order to build a real yields-based return model, we evaluated a number of economic and market variables and compared them to subsequent 12-month returns of the Bloomberg Aggregate Bond Market Index. Through an iterative process, we narrowed the variables to:

- The current Fed funds rate to capture the returns of remaining in cash,
- The current period core CPI to capture the real return on cash,
- 10-year nominal yields to capture nominal return potential,
- 10-year real yields to capture the real return on bonds, and
- Interaction terms among the variables.

The logic here is we are comparing the tradeoff between remaining in cash and facing the current period inflation and buying nominal bonds and facing future expected inflation. As it turns out, analyzing the tradeoff statistically explains about 67% of the variability in 12-month forward bond market returns, a very high explanatory power. While we could improve the model by including measures of credit conditions and other factors, the focus here is on real yields. For a “common sense check,” our real yields model projected the worst returns in history as of Dec 2021, which proved prophetic, as 2022 was indeed the worst year for bonds in contemporary history. Similarly, 2019 modeled returns failed to accurately project bond market returns around the Covid-19 pandemic.



Source: Janney ISG



Source: Janney ISG

As of April 30, 2024, the modeled 12-month forward returns on the Aggregate Bond Market Index is 5.6%, with a standard error of +/- 0.4%. For context, that is the second-highest modeled forward return in over a decade, bested only by the modeled forward returns from October 2023. No model is a perfect representation of the financial markets, as the failures in 2019 show. But based on real yields, spring 2024 is one of the best entry points to add to fixed-income allocations and/or to extend portfolio durations to capture potential forward returns.

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