FIXED INCOME

Does Duration Extension Enhance Long-Term Expected Returns?

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In the past, investors have been rewarded for extending the duration of their fixed income holdings when the yield curve is upward sloping, but have not been rewarded (or have even been punished) when the curve is inverted. Thus, curve steepness is a decent bond market timing signal — and an even better country-selection signal.

However, yield curve shape reflects both a required term premium and the market's expectations of future rate changes. The latter part creates a wedge between the term premium and curve steepness. A very steep (or inverted) curve may reflect abnormally low (or high) short rates and the market's expectation that rates will return to normal. For this reason, I also study the survey-based term premium. We simply subtract from the latter a consensus forecast of future rate changes.

The survey-based premium was as high as 3% to 4% during the inflationary 1980s but fell to near zero in the 2000s, where it remains. That is, even when the Treasury yield curve was at record steepness in the past year, the shape could be fully accounted for by the market expecting short rate increases from zero to more normal levels in a few years' time. There was no additional term premium built into market pricing, which suggested that Treasuries offered pretty poor value.

As always, one could combine the information in curve steepness with other indicators to forecast rewards for duration extension. The most promising predictors include indicators related to economic growth, inflation and bond-market momentum.

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