Hutchinson
CAPITAL MANAGEMENT

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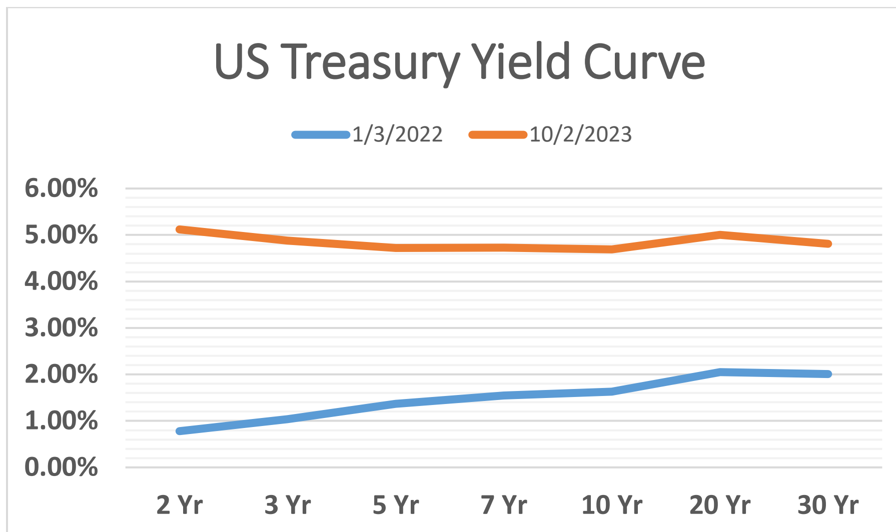
INVESTMENT PERSPECTIVES

Treasury Bill and Chill?
As the old saying goes, what a difference a year makes. After nearly a decade of short-term interest rates being close to zero percent, 2023 will be a year marked by its rapid interest rate hikes and the significant impact this had on the markets. Real estate, mortgage rates, bonds, stocks, and other assets are all affected by interest rates. When rates are low, the cost of borrowing is inexpensive. Conversely, as interest rates climb, the increased cost of borrowing affects things like owning real estate and running a business. Now with short-term interest rates sitting at nearly 5.5%, where do we go from here? Stocks and real estate were considered the "only" investments with attractive yields when interest rates were near zero; however, now Treasury Bills (aka short-term maturing US government backed bonds) are earning over 5% with minimal risk. This has garnered more investor attention for the asset class than we have seen in a long time. In this *Investment Perspectives* we try to explain the allure of Treasury Bills and shed light on other opportunities that have been created in this environment.

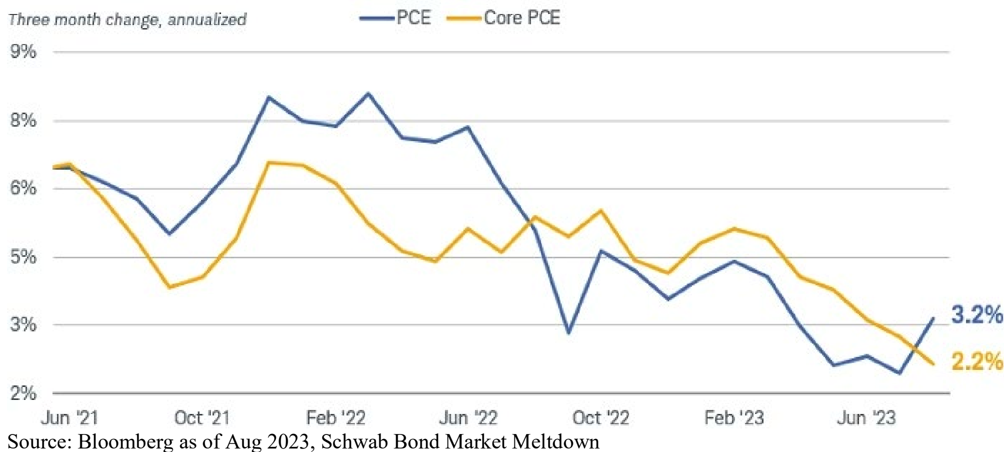
Yield Curve Still Inverted



Source: FRED data as of 10/2/23

More recently, markets have shifted their focus to interest rates, and at the beginning of the year it was loudly predicted that we were barreling towards an inevitable recession. The consensus view was that because of slowing growth, the Federal Reserve would quickly cut short-term interest rates in the second half of 2023 due to a weakening economy. Fast forward to today and the job market has stayed extraordinarily strong, with inflation cooling but continuing to stay above the Fed's stated target. The Federal Reserve's new narrative is "higher for longer" meaning the Fed may have to hold interest rates higher for longer to try to slow down a more resilient, stronger than expected economy. This rapid shift in market sentiment highlights the folly of making investment decisions based on short-term narratives. These narratives are constantly changing, and they are often unreliable guides to *future* market performance.

Inflation Coming Down as Expected



Source: Bloomberg as of Aug 2023, Schwab Bond Market Meltdown

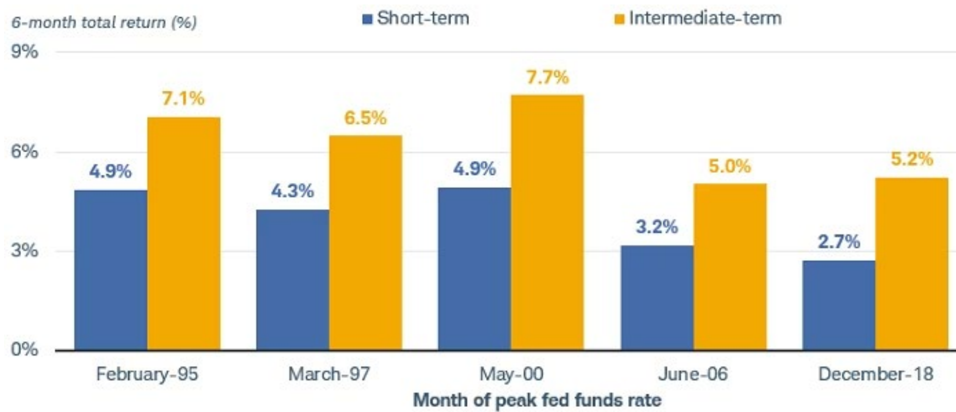
The "higher for longer" narrative is affecting numerous markets, including stocks. As long-term interest rates have risen, investors have sold-off sectors that are seen as "bond alternatives," such as utilities, telecom, REITs, and consumer staples. These sectors are typically known for their steady dividends, but investors are now fleeing to the safety of Treasury Bills. Due to the selloff in these sectors, valuations in these companies have become much attractive and are presenting new investment opportunities.

What is Wrong with 5%?

Even with new investment opportunities in the fixed income market, many investors are wondering why they would ever buy intermediate-term or longer duration bonds when short-term interest rates are at 5% and intermediate-term interest rates at sit slightly above 4%. After all, 5% is better than 4%, right? Not necessarily. For years, short-term bonds have been the better investment, especially in a low interest rate environment. This is because short-term bonds are less sensitive to interest rate changes than intermediate-term bonds. In other words, if interest rates rise, the price of intermediate-term bonds will fall more sharply than the price of short-term bonds. While intermediate-term bonds are more sensitive to interest rate changes than short-term bonds, they also typically offer higher yields. In this environment, we run into two risks by maintaining our bond ladder leveraged to short-term maturities.

Reinvestment risk is a characteristic of short-term bonds but has less of an impact on intermediate bonds. To explain reinvestment risk, if you buy only short-term bonds, you risk that interest rates will fall. This means that when your bonds mature, you will have to reinvest the proceeds at a lower interest rate. For example, if you buy a one-year bond today at a 5% yield, and interest rates fall to 3% next year, you will have to reinvest your proceeds at 3%. This will lower your overall return over time. We invest our clients' portfolios for the long term, not just for today, tomorrow, or next week. For many of our clients, we are not just investing for their retirement, but also for the benefit of their children and grandchildren. We must focus on returns over a much longer time horizon. As a quick reminder, we continue to invest in a laddered bond strategy, which buys bonds maturing in successive years. This strategy is well suited to rising interest rate environments.

Intermediate-Term Bonds have Outperformed when the Fed is Close to Finished Hiking Rates



Source: Bloomberg as of 02/28/23, Schwab Q3 Bond Market Meltdown

Another consideration is a fancy bond term called "carry." Carry is a term used to describe the income generated by an investment, typically in the form of interest or dividends. In the context of bonds, carry refers to the current interest rate on a bond. If the Federal Reserve is closer to the end of its rate hiking cycle, then interest rates are likely to remain stable or even decline. This would make longer-term bonds more attractive, as they offer a higher yield than shorter-term bonds. For example, if you buy a 2% bond, it will generate half the income of a 4% bond. This means that if interest rates rise, you will have less protection against those rate hikes. As longer-term interest rates rise, the more attractive they become for their *future* return and carry potential.

In conclusion, the investment landscape has changed significantly in 2023, led by rising interest rates and a shift in market sentiment. With these changes we are steadily looking to find new opportunities that are consistent with our long-term investment approach. New and changing environments often call for a shift in our thinking. As value investors we continue to look at things from a unique perspective and that doesn't always align with the market consensus.

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