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Has Bond Duration Risk Peaked?

Key Points:

- *Our proprietary Bond Duration Risk Index (BDRI) remains well below its recent peak, which suggests that the risk associated with longer fixed-income duration/maturities is easing.*

- *If BDRI falls further in upcoming estimates, it will be a signal a higher degree of confidence for expecting that the risk-reward outlook will favor extending duration and maturities.*

- *Key factors that will influence the directional path of BDRI include incoming inflation data and the outlook for US economic activity. On both fronts, lower estimates would be bullish for extending duration/maturities.*

The Federal Reserve is expected to start cutting interest rates in the near term, perhaps as early as the September 18 FOMC meeting, based on the implied probabilities derived from Fed funds futures. That growing if still somewhat modest confidence that a dovish pivot for monetary policy is approaching is also resonating in our proprietary Bond Duration Risk Index (BDRI), which aggregates several indicators that offer context for assessing the outlook for the degree of risk related to duration and maturities (as explained below).

Composite Bond Duration Risk Index
monthly

Data: St. Louis Fed macro-markets.com

As the chart at left shows, the latest monthly print for BDRI has fallen from its recent peak of 7 to 4 (as of the current estimate for June, based on data through June 17). If this index declines further in the coming days and weeks, it will signal a stronger case for holding longer maturities and raising the level of duration in fixed-income portfolios. (Note: although the index's frequency is monthly, the current month's estimate is updated daily as new data becomes available for a portion of the underlying components.)

The index ranges from 0 (nil risk) to 7 (high risk). BDRI's peak of 7 in late-2022 reflected all seven of the index's underlying data sets signaling high risk.

The current reading of 4 reflects four of the seven components signaling high risk, the lowest since February. As recently as late-December 2023 the index was at 3, a reflection of market optimism that the Fed's rate-hiking cycle had ended and rate cuts were near. The optimism proved to be premature as 2024 began, but markets are signaling a revival in dovish policy expectations, as shown by the recent decline in BDRI.

The table below details the current readings for each of the seven components that comprise BDRI. For details on how the signaling is calculated, see the summary that follows.

Indicator	Date	Signal
10yr/2yr yield curve (daily)	2024-06-17	High Risk
10yr/3mo yield curve (daily)	2024-06-17	High Risk
2yr yield trend (daily)	2024-06-14	Moderate/Low Risk
2yr yield/Fed Funds spread (daily)	2024-06-14	Moderate/Low Risk
Inflation trend (monthly)	2024-05-31	Moderate/Low Risk
Term premium: 5yr (monthly)	2024-05-31	High Risk
Term premium: 10yr (monthly)	2024-05-31	High Risk

- Inverted yield curves = high risk because shorter maturities offer higher yields than longer maturities. Alternatively, when longer maturities offer higher yields vs. shorter maturities, a moderate/low risk condition prevails.

- 2yr yield trend is calculated as the ratio of 20-day EMA/50-day SMA. When the ratio is rising (values >1.0), the signal is high risk because the trend forecasts rising interest rates. Alternatively, if the ratio is falling (values <1.0), a moderate/low risk condition prevails.

- When the 2-year yield is above the Fed funds target (values > 0), this spread forecasts that the Federal Reserve will raise interest rates in the near term – a high risk condition. Alternatively, if the 2-year/Fed funds rate spread is negative (values <0), this spread is forecasting a near-term cut in the Fed funds rate, which is a moderate/low risk condition.

- To estimate the inflation trend, the Atlanta Fed's Sticky Core Consumer Price Index (CPI) trend is used. The signal is derived as the mean of three trailing-period changes: 3-month, 6-month and 12-month. When the mean of these changes positive (values >0), inflation is trending higher, which is a high risk condition. Alternatively, when the CPI trend is negative (values <0), inflation is trending down, a moderate/low risk condition.

- Term premia = high risk when <0, which indicates no compensation for taking on duration. By contrast, when term premia are >0, investors are offered compensation for longer duration. The term premia are calculated by a NY Fed model for estimating how much, if any, compensation is provided for bearing the risk that interest rates may/will change over the life of the bond. This form of term premia is not directly observable and so a model is required to estimate the data. The model presented here is one of many and it's fair to say the estimates vary, someone substantially.

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