Caron's Corner Transcript – 10.9.2023

Is it Finally Time to Get Long of Bonds?

- Get long of bonds? **No.** Add duration? **Yes.** There is a big difference.
- For those who have followed my audiocasts this year, you will know that we have advocated being underweight - or short - duration all year.
- Our target duration has been 3 years compared to an index level of neutral, about 6 years. This equates to **an underweight of duration of 3 years.**
- As bond yields move close to 5% for the UST 10-year, we think this is a good opportunity to reduce the underweight and add duration to portfolios.
- However, we are **NOT** yet advocating moving above index duration levels or going long. Why? We discuss in this audiocast.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Is it finally time to get long of bonds? Get long? No. Add duration? Yes. Let me explain the difference. For those who follow my audiocasts all year, you'll know that we advocated being underweight, or short, duration all year. Our target duration has been three years versus an index level of neutral duration, which is about six years. So this equates to an underweight, or short duration, of about three years. As bond yields move within the 5% UST 10-year range, we think this is a good opportunity to reduce the underweight and add duration to portfolios. However, we are not yet a advocating moving above index duration levels or going long. Why? Let's get into it.

Closing some of our short, but not going long. That's the key message. At these yield levels, say the UST 10-year around 4.8%, it's starting to price and even trade slightly cheap to a no-landing scenario in our estimation. This is based on our economic fundamental models at this point in the cycle. As a result, we think an investor is getting some value at these yield levels relative to the distribution of economic outcomes. So we are in the soft landing or mild recession camp, which at these elevated yield levels looks increasingly fragile. The risk is you get a no-landing scenario or growth accelerates higher. Now we think this is unlikely, but what if it happens? If we incorporate the bigger picture and factor in term premium versus policy rate expectations, then it can be fair to say that we have a possible range of the UST 10-year between 3.5% and 5.5% over the next one-year period. This is also aligned coincidentally with what the market options are actually pricing right now. So there is risk to adding duration here, as yields could go higher. This is why we advocate adding duration, or starting to close the short positions in bonds, as opposed to going long.

So what are the benefits to buying bonds at these levels? We think the main benefit is that bonds around these levels may now represent a hedge to riskier assets such as equities in a balanced portfolio. Let me tell you why. Similar to last year, one of the main risks in portfolios was a high correlation between equity and bond returns. Simply put, bond yields were still too low and not only needed to rise, but rise without hurting equity performance. We observed this during this year as bond yields rose along

with equities. But now we're observing something different. The recent rise in bond yields is driving equities lower. This is high correlation risk, but it can only go so far until the drop in equity stops the selling in bonds, and perhaps even drive some money into them. It's extremely difficult to call a change in correlation and we're not trying to do that. Instead, we are looking at bond valuations independently relative to yield ranges from economic scenarios and concluding that bonds have value at these levels. Again, note that this is the first time we're making this statement this year. We've been underweight all year long.

Now, weirdly, once this yield rise settles down, it may actually de-risk markets by reducing correlation risks. In other words, bonds may represent a valid hedge against equities. And perhaps even more weirdly, if this happens and also nothing breaks or fundamentals don't change and we still believe in a softer landing, then it could catalyze a recovery or dip buying opportunity in equities. Why? Because it's not just the level of yields that matter, but perhaps more importantly, it's the change in yields. It's the delta that matters the most for correlation risks. It's pure math, but it's very critical to understand this point. Said differently, correlation cuts both ways. If the rise in equity and bond return correlations that caused the sell-off reverses, then falling correlations can create a rally. We still maintain a small overweight to equities and are looking for an opportunity to buy the dip. We will take our cue from changes in bond yields.

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CRC 6001393 Exp. 10/31/2024