Extending duration in a slowing growth environment

July 2023

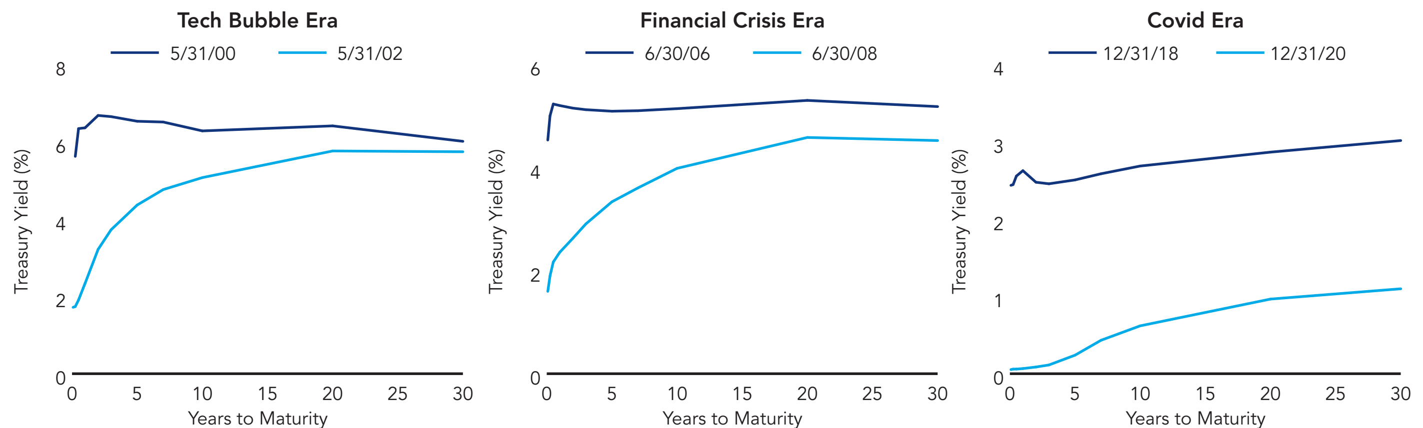
Federated Hermes

- Yields are at levels not seen since before the 2007-08 financial crisis and may be at a cycle peak
- The Fed is at or close to the end of its tightening cycle
- Overall, economic growth is likely decelerating and inflation is declining
- Current yield and duration levels present a favorable return profile across the curve

Following 500 basis points in rate hikes, the Fed skipped a mid-June hike, and raised rates 25 basis points in July while indicating that further hikes would be data dependent. The yield curve on July 31 remained inverted with 2-year Treasuries yielding 90 basis points more than the 10-year. Typically, the yield curve begins to steepen in anticipation of a Fed pause and usual easing that follows. As short-term yields decline more than longer-term yields amid the slowing economy, the period from a Fed pause to easing tends to provide potential for attractive returns for bond investors.

Past three hiking cycles – subsequent changes in Treasury and Fed Funds rates

Short yields fell more than long yields and price appreciation occured across the yield curve, mostly resulting in better returns for investors holding longer-dated bonds. We believe the treasury yield curve will likely behave similarly in the future.



Source: U.S. Department of the Treasury

Comparison of prior Fed pauses	Tech Bubble (FFR Peak: 5/31/00)	Pre-Financial Crisis (FFR Peak: 6/30/06)	Pre-Covid (FFR Peak: 12/31/18)	7/31/23 (Pause coming?)
Fed Funds Rate (Cycle peak)	6.50%	5.25%	2.25% - 2.50%	5.25% - 5.50%
Fed Funds Rate (24-months later)	1.75%	2.00%	0.00% - 0.25%	likely lower
Starting 2s10s spread	-0.41%	-0.01%	0.16%	-0.91%
2s10s spread (24-months later)	1.86%	1.36%	0.80%	likely positive

Source: Bloomberg, Federal Reserve, St. Louis Fed, U.S. Department of the Treasury

What if inflation or economic growth remains stronger than expected?

In that event, the Fed likely doesn't meet expectations for multiple cuts in the first half of 2024. The higher for longer Fed policy may cause the eventual recession to intensify. The Fed may then be forced to cut rates even more in future years, even if inflation has normalized. In either scenario, the resulting "bull steepener" would be generally positive for bonds.

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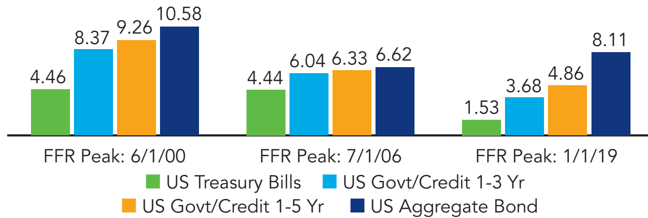
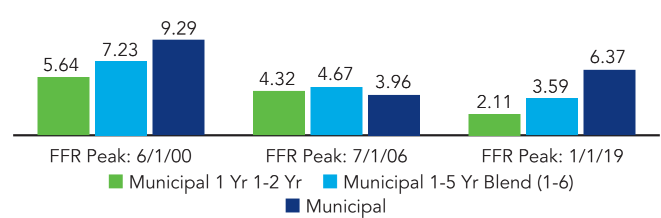
Longer duration outperformed shorter duration following recent pauses

Taxable: 24-month average annual total return (%) following Fed pauses



Municipal: 24-month average annual total return (%) following Fed pauses



Source: Bloomberg Indices

This is for illustrative purposes only and is not indicative of any specific investment. Actual investments cannot be made in an index.
Past performance is no guarantee of future results.

Potential scenarios and approaches to adding exposure to bonds

Investors may want to consider different potential scenarios that could play out for bond markets based on near-term economic outcomes. These are hypothetical scenarios only and there is no guarantee that the bond markets will perform in accordance with any of these scenarios.

Base case

We view the most likely near-term scenario as declining inflation, a mild recession and subsequently falling yields. In this environment, extending portfolio duration by adding to intermediate and longer positions, with a focus on investment grade bonds, historically provides better returns than shorter maturities and lower-quality bonds.

Bond bear case

A more bearish scenario, less likely in our view, would be sticky inflation, additional Fed hikes and yields rising above expectations. As the Fed's response ultimately drives a deeper recession, liquidity investments and short-term bonds would perform well in the near term. Extending duration would become compelling as recession takes hold.

Soft landing case

A less likely but still possible scenario would be a soft landing (no recession). In that case, the Fed stops raising and holds rates steady for a time as inflation approaches it's target level. Extending portfolio duration gradually would enhance return prospects as yields eventually decline when the Fed eases modestly to secure the soft landing.

Conclusion

While the current rate-hiking cycle has been unusual in its scope and rapidity, and in its effect on total returns during 2022, the outlook for bond total returns going forward is positive in our view.

Bloomberg US Treasury Bills 1-3 Month Index: Is a component of the Short Treasury Index. The Bloomberg Short Treasury Index includes aged U.S. Treasury bills, notes and bonds with a remaining maturity from one up to (but not including) 12 months. It excludes zero coupon strips.

Bloomberg 1-5 Year US Government/Credit Index: Is a broad-based benchmark that measures the non-securitized component of the US Aggregate Index. It includes investment-grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities that have a remaining maturity of greater than or equal to one year and less than five years.

Bloomberg 1-3 Year US Government/Credit Index: Includes all medium and larger issues of U.S. government, investment-grade corporate and investment-grade international dollar-denominated bonds that have maturities of between one and three years and are publicly issued.

Bloomberg US Aggregate Bond Index: Is an unmanaged index composed of securities from the Bloomberg Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.

Bloomberg 1-Year US Municipal Bond Index is the one-year (1-2) component of the Bloomberg US Municipal Bond Index.

Bloomberg Municipal 1-5 Year Index is a benchmark that covers the USD-denominated tax exempt bond market with maturities of between 1 to 5 years.

Bloomberg Municipal Bond Index: Is a market-value-weighted index for the long-term tax-exempt bond market. To be included in the index, bonds must have a minimum credit rating of Baa. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990 and must be at least one year from their maturity date.

Indexes are unmanaged and cannot be invested in directly.

Investors should carefully consider the fund's investment objectives, risks, charges, and expenses before investing. To obtain a summary prospectus or prospectus containing this and other information contact us or visit FederatedInvestors.com. Please carefully read the summary prospectus or prospectus before investing.

Past performance is no guarantee of future results.

Mutual funds are subject to risks and fluctuate in value.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

2s10s spread: The difference in yield between the 2-year treasury bond and the 10-year treasury bond is a measure of yield curve steepness. Negative values indicate the 2-year bond yields more than the 10-year bond. Historically, negative values have been a leading indicator of weakening economic conditions.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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