APPLETON PARTNERS, INC.

IS IT CLOSING TIME ON THE SHORT DURATION TRADE?

Drew Peterson, CFA, CIPM®, Corporate Bond Research Analyst and Macro Strategist

It is often said that predicting market direction correctly is much easier than timing. We concur with that sentiment, and one only needs to point to the fact that a year ago Appleton highlighted the risk of holding short-term bonds despite attractive front-end yields. **Those yields are still appealing, although with Fed Funds rate cuts likely on the near-term horizon it's time to revisit the case for adding duration.**

Short maturity bond exposure, by definition, cannot be locked in for long periods of time and therefore exposes investors to future reinvestment risk should yield levels decline. It also bears emphasis that curve normalization is not simply a future eventuality, it has already begun. Over the past four months, 2-year AAA yields have fallen 12 bps to 2.85% while the 10-year AAA has increased 31 bps and the spread between 2 and 10-year maturities has declined 43 bps to 3 bps.[1] **Locking in duration at this point in the cycle with the economy slowing and curve structure beginning to adjust is a timely consideration in our view.**

One of the more important current market dynamics to consider is the sheer amount of money that remains parked in money market funds, up from a pre-pandemic average of around $2.75 trillion to about $6.14 trillion. This growth primarily unfolded in two phases, early 2020 upon the onset of COVID-19, and again in the last 18 months in reaction to an inverted curve's short yield levels. This change has created an enormous pool of liquid assets that may move as investor sentiment changes. We would not be surprised if investors look to extend duration quite rapidly once the Fed begins cutting short-term rates, and reallocation can become a very crowded trade in supply constrained markets such as municipals. **In short, if your intent is to eventually add fixed income duration back into your portfolio by reallocating assets held in money markets or T-Bills, we believe time is of the essence.**

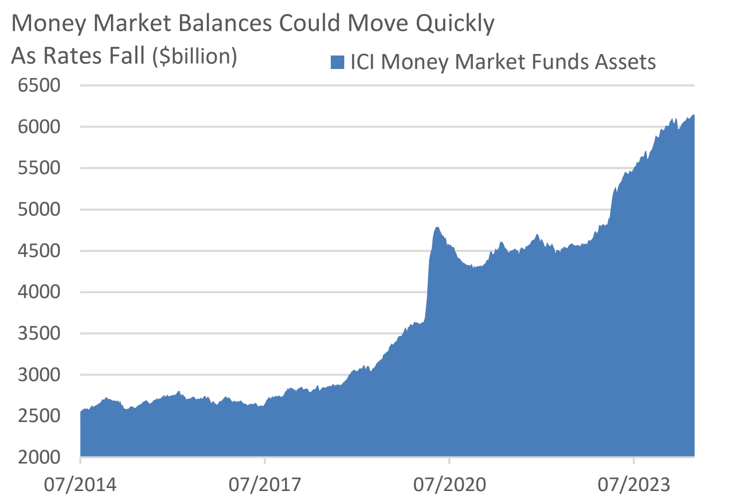
When and how quickly this plays out is unknown, yet bond investors now enjoy a greater "carry," or income from the yield of bonds in their portfolios, than has been the case for much of the past decade. The significance is that more robust yields help cushion the risk of rates moving higher. **We do not expect rates to rise, but were this to occur, the carry available to high grade bond investors is much higher now than a few short years ago.**

Furthermore, if investors are holding cash and equivalents as an alternative to fixed income, it's important to think about the role bonds play in the context of most diversified portfolios. It is tempting to look favorably at a 3-month T-Bill yielding 5.28% as compared to 10Yr USTs at 4.03%[1], yet this is only part of the equation. For most of our clients, fixed income serves as a portfolio "ballast," (not just a source of income) as this exposure is intended to add stability in more difficult markets. **Fixed income duration often produces positive returns when equities are under pressure, thereby mitigating overall portfolio risk.**

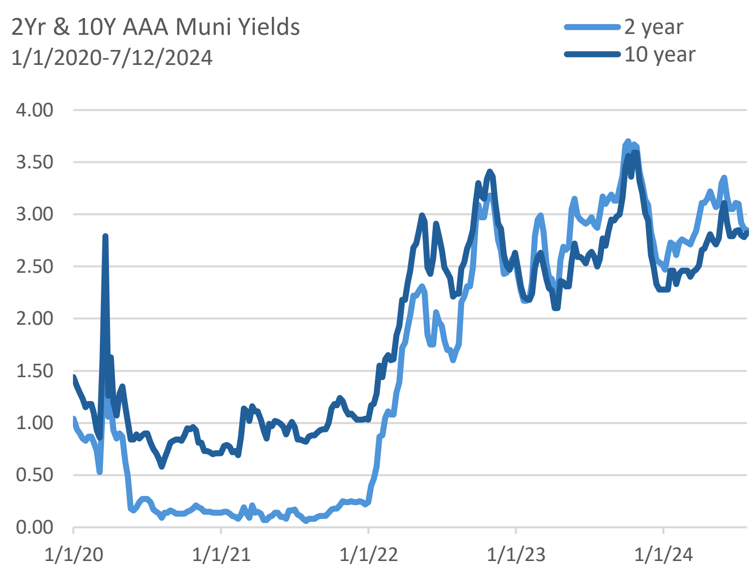
AAA Municipal Yields

	3/31/2024	6/30/2024	7/31/2024
2-year	2.97%	3.11%	2.85
10-year	2.51%	2.84%	2.82
Spread	-46 bps	-27 bps	-3 bps

Source: MMD



Source: Investment Company Institute



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We don't believe a recession is imminent, but recessions are notoriously hard to predict until you are in the middle of one. Long-term bond yields can drop quickly as "flight to quality" occurs, and in such environments, longer duration paper will handily outperform money market funds and Treasury Bills at the time investors need the performance most. **Retaining too much short-term exposure at the expense of duration to capture today's incremental yield risks handicapping the ability of your bond portfolio to do what you need it to in more difficult times.**

We have been discussing the risks of insufficient portfolio duration for nearly a year. Cash and equivalent exposure has likely outperformed longer-term strategic duration targets over the last few years, but we believe closing time on that trade is approaching. **Unwinding overweight short duration positions and returning to more typical long-term cash allocations makes sense to us, and getting ahead of what could be a sudden shift in investor assets would be prudent.**

1. As of 7/31/24