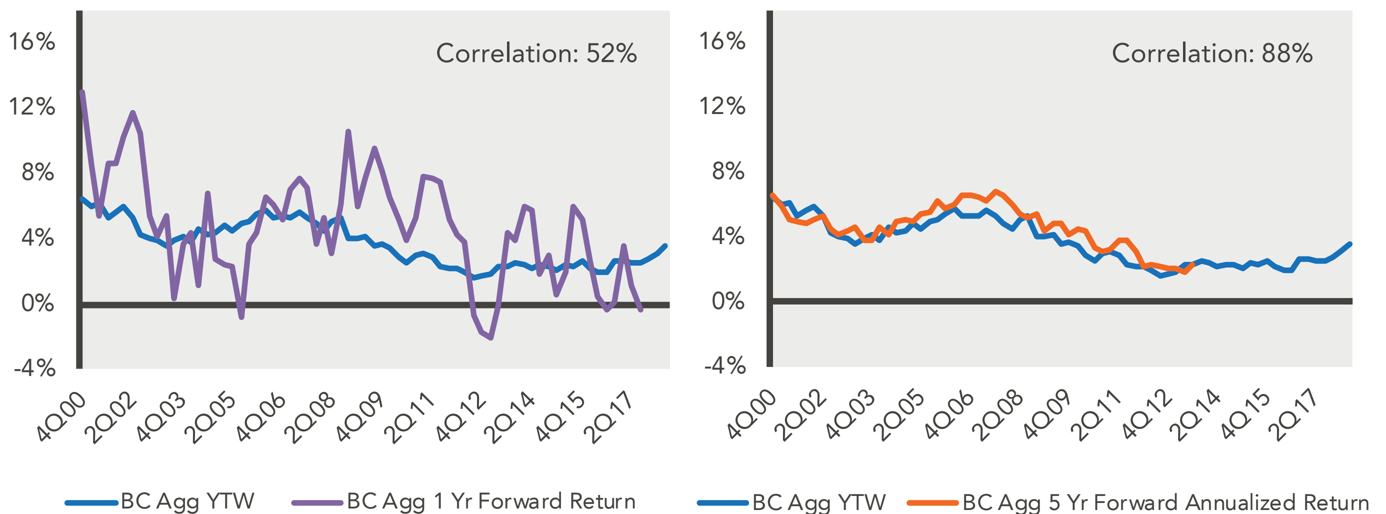
# Deciphering the Bond Markets:
## How Much Duration and Credit Risk Should I Take?

BEN MOHR, CFA, SENIOR RESEARCH ANALYST, FIXED INCOME

Interest rates continue to rise. The Federal Reserve has hiked rates eight times since 2008 and is expected to hike a total of four times in 2018, with potentially three to four more hikes in 2019. The European Central Bank is expected to hike next year, and the Bank of Japan will soon hike as well. Given the continued rise in rates, how much duration should we hold in our portfolios?

As rates rise, duration will be hurt, but we would advocate holding more duration than too little. Because, as rates change, bond returns match their yield over time. Both charts below show the yield of the broad bond index, the Bloomberg Barclays U.S. Aggregate ("Agg"), in blue. The purple line on the left shows the Agg's one-year forward return at each point, while the orange line on the right shows the Agg's five-year forward return. In the shorter term, there will be volatility due to interest rate changes, but in the longer term, a bond's return smooths out to its yield.

**As rates change, bond returns match their yield over time**




Source: Bloomberg

We hear a lot that interest rates are certain to go up and, because of that, we shouldn't hold a lot of duration in our portfolios. But it's more nuanced. It's not a slam dunk. It's a natural reaction that, as rates go up, we'd want to shorten duration, but we need to remember that (1) duration provides principal protection; (2) the yield curve is very flat and close to inversion[1] — although part of the reason that it's flat can be attributed to foreign demand — and duration could help weather a potential oncoming recession; and (3) as rates change, a bond's return over time matches its yield, shown in the chart above. So, all in all, there are times when all the signs are pointing us toward more duration or less duration, but for the current time being, we'd want to stay moderate.

CONTINUED >

Besides duration, credit risk is currently another key investor concern. How much credit risk should we take in our portfolios? Prices are very rich for bonds right now. But with the high prices in bonds today, just like with an expensive luxury car, are there features and fundamentals that support the high price? Based on our assessment of credit risk, we'd want to take a moderate amount of credit risk as well, as (1) spreads are tight; (2) fundamentals are moderate-to-cautious; and (3) the U.S. bank loan and high yield maturity wall is pushed out, but the emerging markets debt maturity wall is looming, which has potential spill-over effects. Just like with our duration guidance, there are times when all signs were pointing to taking less credit risk, such as 2007, or taking more credit risk, such as 2010, but for right now, we'd want to stay moderate.

Ultimately, a key result from assessing how much duration and credit risk to take can lead to a view of which inning of the credit cycle we are in. So, which inning are we in? Given the flat yield curve, moderate-to-cautious credit fundamentals and rich bond prices, it looks like we're most likely in the 7$^{th}$ inning. And we may stay in the 7$^{th}$ for some time — the 7$^{th}$ inning stretch, if you will.

[1] Historically, an inverted yield curve has been a harbinger for a recession.

**PREPARED BY MARQUETTE ASSOCIATES**

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO I BALTIMORE I PHILADELPHIA I ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

*The sources of information used in this report are believed to be reliable. Marquette Associates, Inc. has not independently verified all of the information and its accuracy cannot be guaranteed. Opinions, estimates, projections and comments on financial market trends constitute our judgment and are subject to change without notice. This material is not financial advice nor an offer to purchase or sell any product. References to specific securities are for illustrative purposes only and do not constitute recommendations. Past performance does not guarantee future results.*

## About Marquette Associates

Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions.

For more information, please visit www.marquetteassociates.com.