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RELATIVE VALUE OPPORTUNITIES IN THE LONG END OF THE US TREASURY CURVE

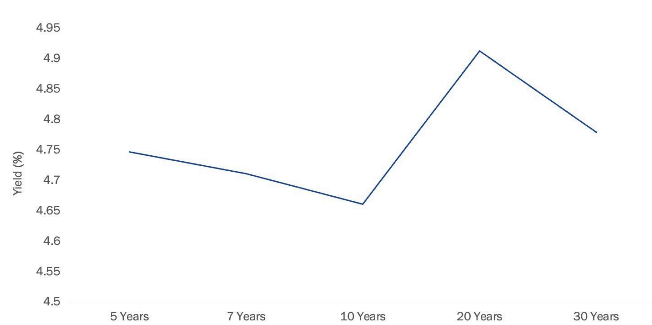
By Samuel Kaplan, CFA — May 10, 2024
9 mins

WHY JENNISON BELIEVES THE 20-YEAR POINT IS ATTRACTIVE

In May 2020, the US Treasury reintroduced issuance of "on-the-run" 20-year Treasuries. Increased supply due to fiscal stimulus in the wake of the COVID-19 pandemic coincided with a spike in interest rate volatility, which caused leveraged, short-term investors to unwind their carry trades and sell their positions in longer-dated securities centered on the 20-year point of the US Treasury curve. This resulted in a dislocation in the long end of the US Treasury curve in which 20-year Treasuries yielded more than both 10-year and 30-year Treasuries that started in the fourth quarter of 2021. That dislocation still persists today.

By our measures, the 20-year Treasury offered the most significant relative value in July 2022. Since that time, the 20-year point has outperformed the 10-year and 30-year by ~20 basis points (the 10s-20s curve is 25 basis points flatter and the 20s-30s curve is 18 basis points steeper). Despite the consistent richening over the last year and a half, the 20-year point continues to be attractive in the current environment, yielding approximately 10 basis points more than 30-year Treasuries and approximately 25 basis points more than 10-year Treasuries (Exhibit 1).

Exhibit 1. 20-Year Treasuries Continue to Offer Attractive Relative Value



Sources: Analytics Provided by The Yield Book® Software. As of April 30, 2024.

The 20-year portion of the yield curve continues to benefit from a confluence of tailwinds. The abnormal supply/demand environment that helped create the uptick in 20-year yields has shifted in the other direction. Recent US Treasury supply increases have been focused on other surrounding parts of the yield curve and the US Treasury's announced buyback program is likely to target higher yielding off-the-run bonds. In our view, this dynamic along with still compelling valuations makes off-the-run bonds in the 20-year part of the Treasury curve one of the most attractive ways to add yield and carry to portfolios from a risk-adjusted return perspective.

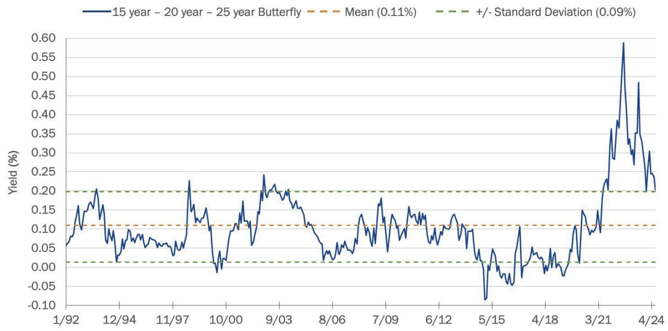
HOW JENNISON CAPITALIZES ON THIS MARKET OPPORTUNITY

Treasuries are non-principal at risk trades, which gives Jennison's fixed income team the ability to rotate between bonds without concerns around default risk.

The investment team uses different strategies to capture this market opportunity across Jennison's various fixed income portfolios, all while maintaining duration neutrality versus the respective long duration benchmarks we manage against.

One strategy is a relative value trade, where we buy off-the-run 20-year Treasuries while concurrently selling equal duration off-the-run 15-year and 25-year Treasuries (also known as a butterfly trade). As an example, off-the-run bonds in the 20-year segment are currently yielding approximately 20 basis points more than those in the 15-year segment and are on par with the 25-year segment, illustrating the low-risk nature of adding yield and carry to portfolios through this approach. Furthermore, we believe this strategy makes a fixed income portfolio well positioned to potentially generate alpha as the curve continues to normalize from its extremely dislocated levels (Exhibit 2).

Exhibit 2. Capturing the Relative Value of the 20-Year

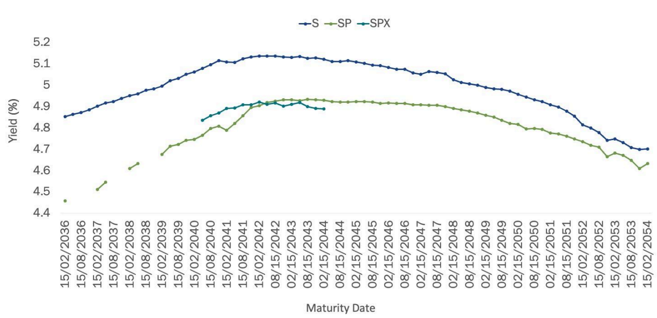


Sources: Jennison Associates LLC and Analytics Provided by The Yield Book® Software. January 31, 1992 – April 30, 2024. The above time frame represents long term historical market cycles.

Additionally, yield and potential returns can be enhanced further by utilizing STRIPS in the 20-year part of the curve. STRIPS allow investors to pay a fraction of a dollar today to get back a full dollar at maturity. Given the lower cash outlay required by STRIPS to get the same duration, excess cash can be allocated to other asset classes with potential attractive returns.

The recent rise in long dated yields coupled with increased stripping activity and demand for 30-year Principal STRIPS (Ps) has led to greater supply of Coupon STRIPS (Coups) across the curve. As a result, the spread between Ps and Coups is at all-time-wide levels (range is 15-25 basis points) in the 20-year part of the curve. For only a small increase in liquidity risk, we believe investors can significantly increase the carry of a portfolio, which can help insulate losses should the 20-year part of the curve start to underperform again, and also boost returns while we wait for curve normalization to occur.

Exhibit 3. Long Dated STRIPS Offer Additional Relative Value Opportunities



Sources: Bloomberg. As of April 30, 2024.

Overall, we believe the 20-year Treasury is a compelling way to increase yield and set-up portfolios for potentially attractive total returns as the yield curve normalizes.

By Samuel Kaplan, CFA
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A Note About Risk

Investments in bonds are subject to market risks as well as issuer, credit, prepayment, extension, and other risks. The value of an investment is not guaranteed and will fluctuate.

There is no guarantee our objectives will be met. All investments contain risk, including possible loss of principal. The strategy may vary significantly from the benchmark in several ways including, but not limited to, sector and issuer weightings, portfolio characteristics, and security types.