DoubleLine®

Owning Treasuries as an Offset to Credit Risk

Sam Nussbaum | December 2022

Key Takeaways

- U.S. Treasuries can offer distinct diversification benefits to fixed income investors.
- Several leading economic indicators have deteriorated this year, pointing toward increased recession risk for 2023.
- Treasuries tend to outperform other fixed income sectors during recessions and act as a deflation hedge.
- The broad upheaval in fixed income markets in 2022 has led to enhanced yield profiles and potentially positive real yields for Treasuries should inflation recede.

Effective Diversification – A Barbell Portfolio

2022 has proved to be a historically adverse environment for investors and, more specifically, one of the worst years of return on record for many fixed income sectors. Monetary policy tightening to combat decades-high inflation, interest rate volatility and fears of a recession coincided to cause steep drawdowns. Correlations across fixed income sectors rose over the year, perhaps leading some to question the case for diversification. However, DoubleLine believes diversification is the cornerstone of active management and an equally effective risk-management tool. The need to balance duration risk and credit risk, arguably the two most prominent risk premia in fixed income investing, is as important now as ever, as investors are likely to confront increasing macroeconomic uncertainty in 2023.

Treasuries can offer distinct benefits in a portfolio: pure duration exposure, positive carry and credit-risk offset. All these attributes make Treasuries an attractive part of any diversification mix over a full market cycle, but the benefits are magnified in recessionary periods.

Recession Risks Rising

Several leading economic indicators have deteriorated year-to-date, raising the prospect of a recession in 2023. Among the many measures that the DoubleLine team watches closely is the Conference Board Leading Economic Index (LEI) year-over-year (YoY) change, which turned negative in July. Historically, when the YoY LEI has turned negative, a recession has generally followed. *(Figure 1)*

Rising recession risks are also evident in the shape of the Treasury yield curve, which is inverted as measured by the spread between the two-year Treasury yield and 10-year Treasury yield. *(Figure 2)* Historically, an inverted yield curve has provided insight into the onset of the last six recessions since 1978. The yield curve tends to invert anywhere from four months to two years before a recession.

With the benefit of foresight into leading indicators of economic weakness, active managers can allocate to Treasuries at one end of a barbell portfolio to help offset the potential volatility and/or drawdowns introduced by credit-sensitive sector exposures in a coming recession.

Conference Board LEI | As of November 30, 2022

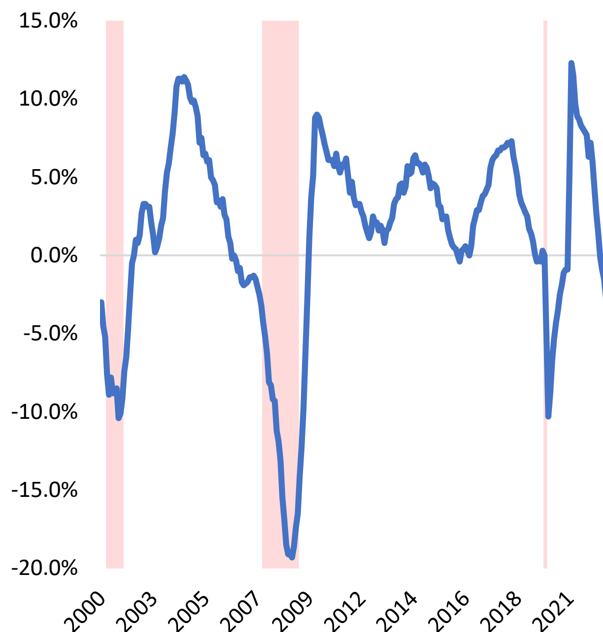


Figure 1
Source: DoubleLine, Bloomberg.
Red shaded areas indicate recessionary periods.

10-Year Yield Minus Two-Year Yield | As of November 30, 2022

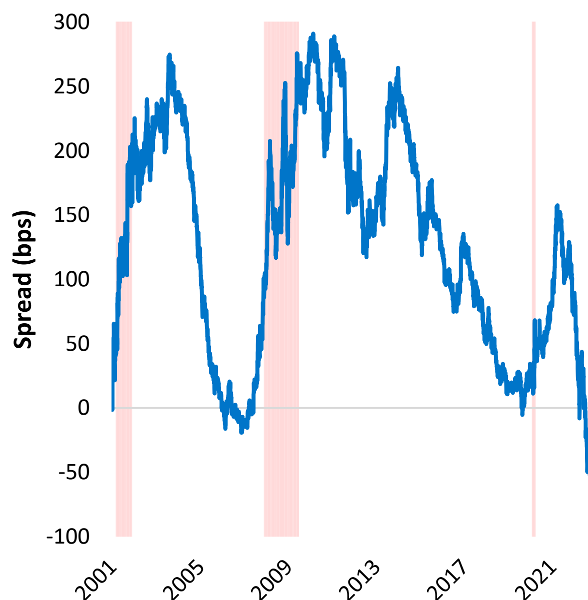


Figure 2
Source: DoubleLine, Bloomberg
Red shaded areas indicate recessionary periods.

Outperformance When it Counts

Treasuries can provide risk-offsetting exposure as they have historically outperformed other fixed income sectors during recessions and provide an allocation that can be deployed to credit-sensitive sectors after spreads have widened. In the past six recessions since the inception of the Bloomberg US Treasury Index in 1973, Treasuries have outperformed investment grade (IG) corporate bonds, as measured by the Bloomberg US Corporate Bond Index, by an average of 421 basis points (bps) 12 months after the start of recession. Moreover, Treasuries have outperformed high yield (HY) corporate bonds, as measured by the Bloomberg US Corporate HY Bond Index, by an average of 1,120 bps over the last four recessions. (Figure 3)

Elevated inflation, a key theme of 2022, is running at roughly four-decade highs and has pushed the Federal Reserve to tighten monetary policy at a historic rate. *(Figure 4)* Measures of inflation are widely expected to decline in 2023, largely due to base effects and falling goods prices, though the pace at which inflation recedes will likely determine how long monetary policy stays restrictive. As recession probabilities rise, so does the potential for deflation risk. While a deflationary scenario is broadly not in DoubleLine's base-case view, Treasuries can act as an important portfolio hedge in such an environment, too. In a deflationary environment, where asset values are likely falling, fixed coupon payments of Treasuries are an important and stable source of return.

Post-Recession Performance

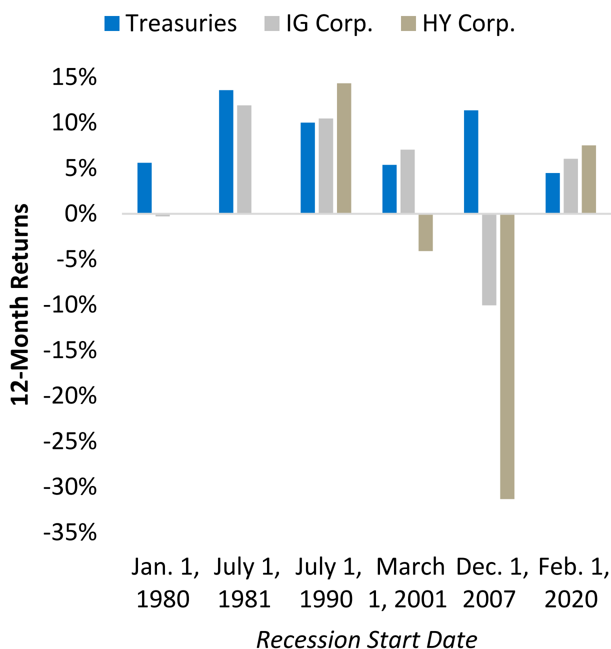


Figure 3
Source: DoubleLine, Bloomberg

U.S. Consumer Price Index | As of November 30, 2022

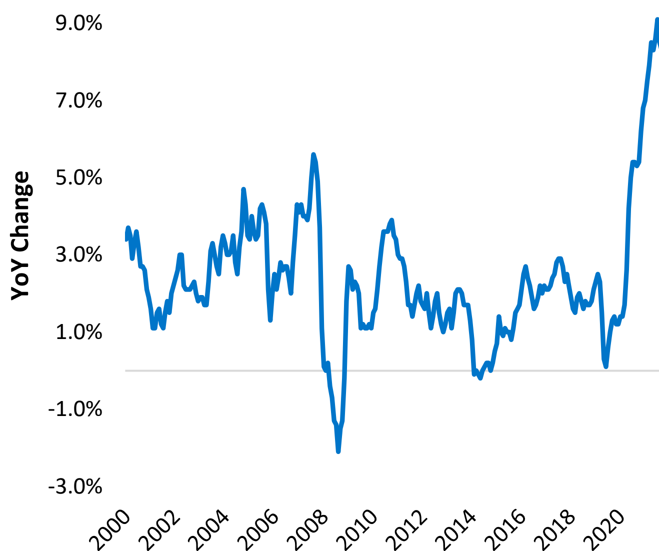


Figure 4
Source: DoubleLine, Bloomberg

Positive Carry and Real Yield Contributing to Return

The broad upheaval in fixed income markets in 2022 has led to higher Treasury yields across the curve. *(Figure 5)* Treasuries across various tenors are now generally yielding more today than they have at any point in the past decade. Should measures of inflation trend lower in 2023, Treasury yields could also broadly offer positive real yields in excess of inflation. The sector's carry also adds incremental portfolio yield in a barbell portfolio where credit-sensitive sectors could be subject to default risk imperiling interest income.

U.S. Treasury Yields | As of November 30, 2022

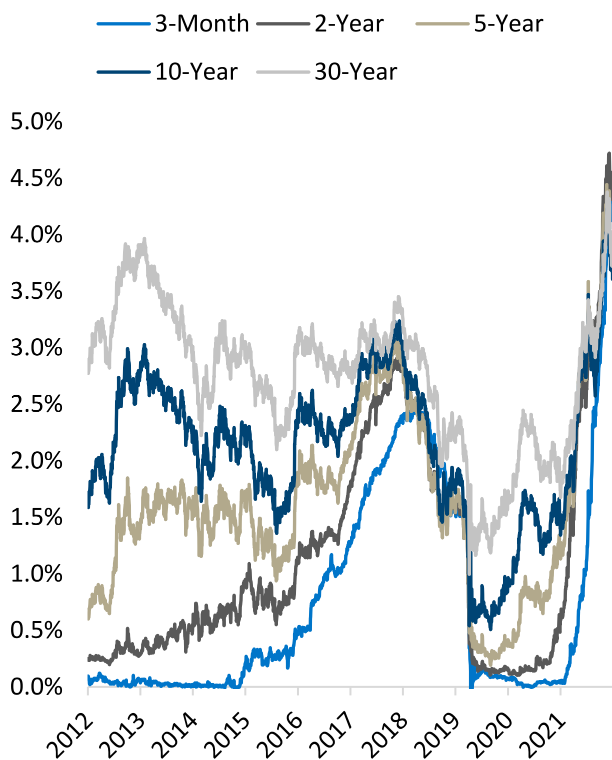
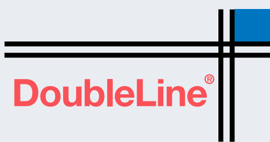


Figure 5
Source: DoubleLine, Bloomberg

Conclusion

The factors that contributed to a historically poor environment for bond investors in 2022 have also created opportunities to reallocate to fixed income at higher yield levels, though investors must ensure that portfolios are well constructed if a recessionary environment materializes. In such an environment, the potential volatility-dampening benefit of owning Treasuries in a barbell portfolio gives active managers the flexibility to simultaneously maintain credit-sensitive exposures. Duration risk and credit risk, which combined to cause painfully negative returns in 2022, are likely to resume their offsetting nature in the year ahead and beyond. In DoubleLine's view, Treasuries are an integral part of a well-diversified fixed income portfolio and an allocation that can provide the certainty of pure duration exposure, positive carry and credit-risk offset in an increasingly uncertain macro environment. ■



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Mr. Nussbaum joined DoubleLine in 2013. He is a member of the Product Specialist Team. In this capacity, he is responsible for various aspects of DoubleLine product marketing, investment strategy updates, portfolio communications and competitive analysis, with a focus on DoubleLine's Fixed Income Asset Allocation strategies. Mr. Nussbaum is also responsible for producing market commentary and dedicated strategy content. As a part of the Product Specialist Team he attends the Fixed Income, Macro, and Structured Product meetings. Prior to DoubleLine, Mr. Nussbaum worked as an Operations Associate for VFG Securities managing client reporting. He holds a BA in Philosophy from the George Washington University and the Series 7 and 63 Licenses.

Basis Points (BPS) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bloomberg US Corporate Bond Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg US Corporate High Yield (HY) Bond Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindexes of the Bloomberg US Corporate HY Bond Index.

Bloomberg US Treasury Index – This index measures U.S. dollar-denominated, fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Carry – The carry of an asset is the return obtained from holding it (if positive), or the cost of holding it (if negative).

Conference Board Leading Economic Index (LEI) – This index tracks a group of composite indexes (manufacturers' orders, initial unemployment insurance claims, et al.) as a means of gauging the strength of a particular industry or the economy.

Consumer Price Index (CPI) – This index, compiled by the U.S. Bureau of Labor Statistics, examines the weighted average of the prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by averaging price changes for each item in the basket. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

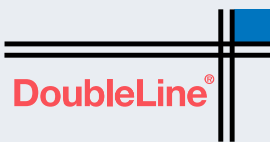
High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

Real Yield – Yield adjusted for inflation.

Spread – Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk..

You cannot invest directly in an index.



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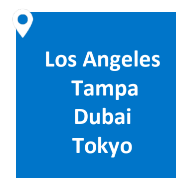

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