Global Sustainable Total Return Bond Strategy

INVESTMENT LETTER | OCTOBER 2023

The Brown Advisory Global Sustainable Total Return Bond strategy seeks to take a global, sustainable, and dynamic approach to fixed income. We believe that dynamic asset allocation informed by comprehensive top-down macro analysis, combined with rigorous, bottom-up security selection and a differentiated sustainable investment approach, can deliver an attractive stream of income and risk-adjusted returns through the economic cycle while producing positive environmental and social impact.

Portfolio Managers

Chris Diaz, CFA

Ryan Myerberg

Colby Stilson

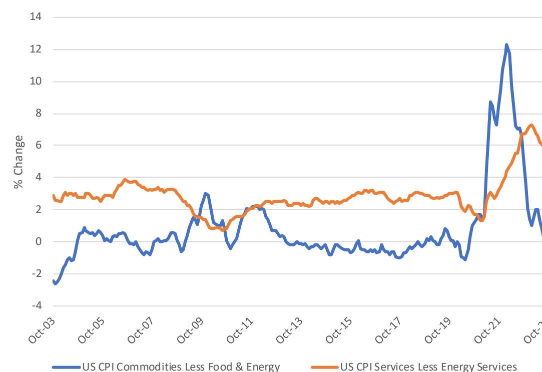
U.S. Interest Rates: Back to the Future

In what had been dubbed the "Great Bond Massacre," 10-year U.S. Treasury yields increased from 5.3% to 7.8% between July 1993 and October 1994[1]. Much of the cause for that sharp increase in rates was attributed to concerns surrounding profligate government spending and the necessary government bond issuance required to fund those deficits. At the time, James Carville, a well known political advisor to Bill Clinton, remarked "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

As empirically minded investors we'd likely need multiple (and verifiable) examples of reincarnation to jump fully onto that metaphysical bandwagon, but we have now seen a sustained rise in interest rates that mirrors, in some ways, that massacre from the nineties. Since the first trading day of 2022, 10-year U.S. Treasury yields have increased from 1.5% to a whisper below 5.0% at time of writing[1]. In our view, the rise in interest rates has been a combination of factors: some new, some old, and some we just have not thought about in a long time. The "new" refers to a possible regime change into a higher neutral rate of interest, suggesting elevated long-term rates will be with us for the foreseeable future. The "old" is the well-worn debate of term premium, or lack thereof, in fixed income markets. And what we "have not thought about in a long time" is the impact on interest rates from fiscal malfeasance in the form of large budget deficits as far as the eye can see. We will briefly explore each of these issues and share our views on how this translates into portfolio positioning.

The New Neutral Rate?

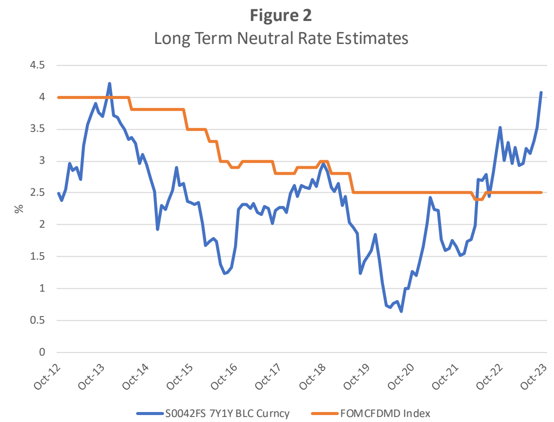
One debate that has picked up steam in recent months has centered around the nominal neutral interest rate. The neutral rate is the theoretical Fed Funds Rate that neither stimulates nor restricts the economy. The Federal Reserve concedes the neutral rate is hard to identify in real-time, if nigh-on impossible, and thus challenges the assessment of the current level of monetary restrictiveness. A restrictive interest rate is meant to slow the pace of economic activity and inflation by constraining demand. In the U.S., while inflation has eased, it has mainly come from the goods producing sector that is now recovering from the supply-side disruptions caused by the pandemic. Service sector inflation continues to run well above levels consistent with price stability (Figure 1). This likely stems from the



[1]CNBC.com – US 10 Year Treasury https://www.cnbc.com/quotes/US10Y/

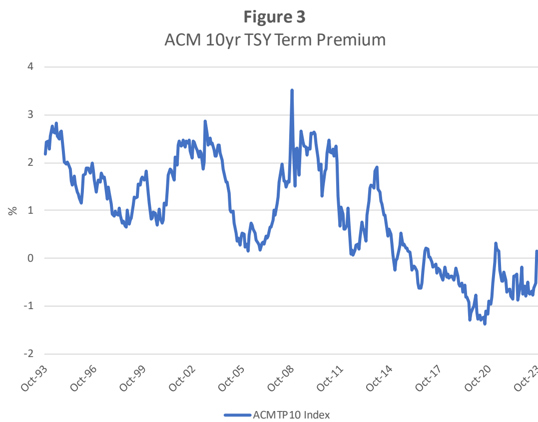
For institutional investors and professional clients only.

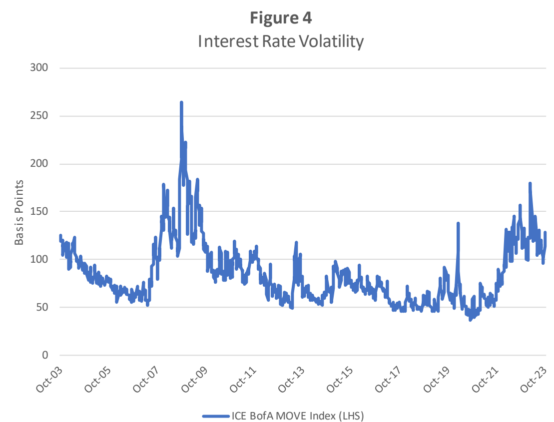
resilience of growth, and the labour market, more specifically. In response to these developments, market-implied interest rates have deviated from the Federal Reserve's estimate of the neutral rate. The Fed's published estimate of the long-term neutral rate is 2.5% but that view is continuing to evolve in today's market environment. One method of extrapolating the market's view is to observe long-term Overnight Index Swap (OIS) contracts. As of October 17th, that number was 4.3% (Figure 2).



Term Premium is back, baby… maybe?

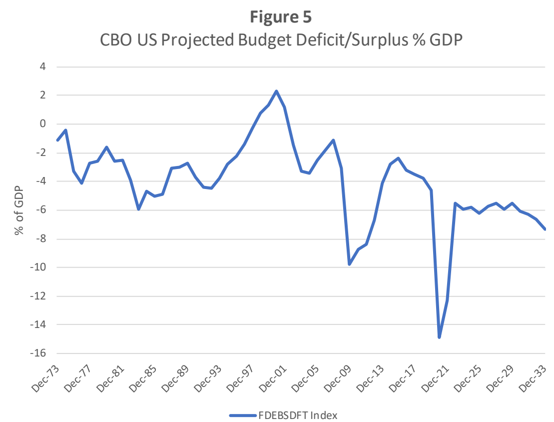
There has also been increased discussion of the return of term premium in bond markets. Term premium is defined as the additional compensation investors require above the expected path of short-term interest rates for shouldering the risk of assets with longer maturities. The widely followed Adrian, Crump, and Moench (ACM) model provides an approach for extracting the embedded term premia from U.S. Treasury yields (Figure 3). In the last 10 years, the average term premium in this model has been -0.3%. In the previous 20 years (1993-2013), the model averaged 1.5%. Yet debate around unexpectedly low term premium emerged as far back as 2005 when Alan Greenspan referred to the "conundrum" of longer rates not following shorter rates higher as the Fed continued to raise the overnight rate. He hypothesized there may be a "global saving glut" leading to excess demand for Treasuries from foreign central banks and sovereign wealth funds. Additional explanations at the time included the low level of interest rate volatility and low-to-stable inflation expectations. As evidenced by the ICE BofA Move Index, fixed income's version of the CBOE Volatility Index (VIX), which captures the volatility of interest rates, the recent increase in volatility has been associated with a move higher in the term premium (Figure 4). While term premia have been increasing, "normal" is still quite a bit higher than current levels suggest.

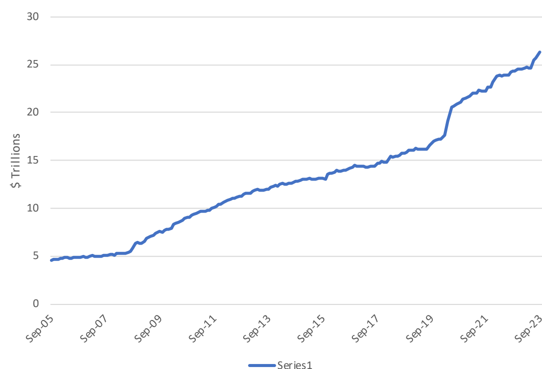




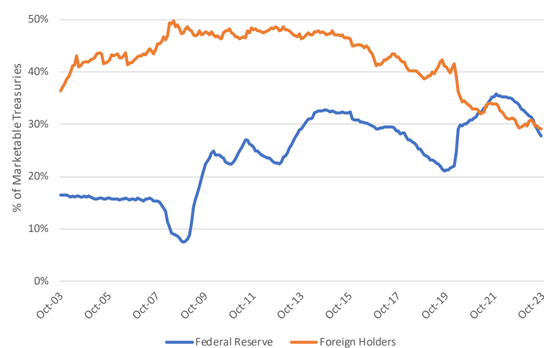
Return of the Bond Market Vigilantes?

The current U.S. fiscal position has deteriorated rapidly over the last 15 years, largely due to the governmental response to the Global Financial Crisis (GFC) and Covid-19 pandemic, but also a continuation of deficit spending across multiple administrations. In their latest budgetary update, the non-partisan Congressional Budget Office forecasted budget deficits of between -6% and -8% to persist through the next decade (Figure 5). The outstanding amount of marketable US. Treasury debt (excluding intra-governmental holdings) is now more than $26 trillion, approximately five times pre-GFC levels (Figure 6, on the next page). We can also speak with confidence that this number will continue to increase at a rapid rate as more than $2 trillion of net Treasury issuance is expected in 2024. The existential





question must be: who is going to buy all of that debt? Our answer…we don't know. The ownership of the Treasury market has been evolving from relatively price-insensitive investors (namely, the Federal Reserve and other central banks) to more price-sensitive investors. Foreigners used to own approximately 50% of marketable Treasuries - today that number is below 30% (Figure 7). The Federal Reserve is also shrinking their balance sheet, bloated by years of Quantitative Easing policies, by allowing $720 billion of Treasury securities to roll off per annum. Additionally, tepid deposit growth for U.S. commercial banks should limit demand from that cohort of market participants. This leaves more price-sensitive buyers such as asset managers and pension funds to balance supply and demand.



Portfolio Implications

As we reflect on the factors highlighted in this piece, we have some high-level considerations. The "new" discussions of the neutral rate include two important features: 1) the dramatic increase in neutral rates and 2) the relatively large delta between our interpretation of the Fed's neutral rate and that of the market's. These two things suggest to us that current interest rates are restrictive and that there is room for the Fed and market to meet in the middle; both of which should be supportive of a bullish steepening of the yield curve (short maturity rates coming down faster than long maturity rates). The "old" discussions of term premia and bond vigilantes that haven't been "thought about in a long time" come together to suggest that term premia are likely to go higher, along with pickier investors that could take a more discerning view of valuation within the U.S. Treasury market in the face of deficit spending and extended balance sheets. This also will likely contribute to a steeper U.S. Treasury yield curve.

A core view of the team is that interest rates matter for many reasons and impact all facets of the economy and investible assets, and the current pace of U.S. economic growth is unsustainable. We believe the resilience of the U.S. economy, relative to peers, is a function of higher levels of pandemic-induced stimulus and a higher proportion of fixed rate debt that hasn't yet fully repriced to the present higher interest rate regime. Therefore, we are avoiding riskier corporate credit and levered business models, in general. An environment of falling growth and inflation should allow the Fed to lower the Fed funds rate, thereby steepening the yield curve in the more traditional bullish manner. If that scenario does not unfold, we believe the factors discussed above will exert further steepening pressure, but in "bearish" fashion, as long maturity yields increase more than shorter maturities. Thus, the highest conviction view expressed in our strategy is a yield curve steepener. Much of this risk is expressed in the U.S. Treasury market, but similar positions are held in the Eurozone, U.K. and Japan. Consistent with our philosophy of focusing on capital preservation in challenging market environments, we have reduced duration to the lower end of our normal operating range. We believe value creation is happening for fixed income assets (albeit at a rapid and painful pace for risk-free duration, and glacially for riskier fixed income) and long duration positioning will prove quite profitable in the quarters ahead.

We thank you for your support and interest in the strategy.

Chris, Colby, and Ryan

For institutional investors and professional clients only.

Past performance may not be a reliable guide to future performance and investors may not get back the amount invested. All investments involve risk. The value of the investment and the income from it will vary. There is no guarantee that the initial investment will be returned.

The views expressed are those of the author and Brown Advisory as of the date referenced and are subject to change at any time based on market or other conditions. These views are not intended to be and should not be relied upon as investment advice and are not intended to be a forecast of future events or a guarantee of future results. The information provided in this material is not intended to be and should not be considered to be a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell, or hold any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable. To the extent specific securities are mentioned, they have been selected by the author on an objective basis to illustrate views expressed in the commentary and do not represent all of the securities purchased, sold or recommended for advisory clients. The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This piece is intended solely for our clients and prospective clients, is for informational purposes only, and is not individually tailored for or directed to any particular client or prospective client.

Sustainable investment considerations are one of multiple informational inputs into the investment process, alongside data on traditional financial factors, and so are not the sole driver of decision-making. Sustainable investment analysis may not be performed for every holding in the strategy. Sustainable investment considerations that are material will vary by investment style, sector/industry, market trends and client objectives. The Strategy seeks to identify companies that it believes may be desirable based on our analysis of sustainable investment related risks and opportunities, but investors may differ in their views. As a result, the Strategy may invest in companies that do not reflect the beliefs and values of any particular investor. The Strategy may also invest in companies that would otherwise be excluded from other funds that focus on sustainable investment risks. Security selection will be impacted by the combined focus on sustainable investment research assessments and fundamental research assessments including the return forecasts. The Strategy incorporates data from third parties in its research process but does not make investment decisions based on third-party data alone.

Terms and Definitions

Duration is a time measure of a bond's interest-rate sensitivity, based on the weighted average of the time periods over which a bond's cash flows accrue to the bondholder.

Volatility is the degree of variation of a trading price series over time, usually measured by the standard deviation of returns.

Yield Curve is a line that plots yields, or interest rates, of bonds that have equal credit quality but differing maturity dates. The slope of the yield curve can predict future interest rate changes and economic activity.

ICE BofA Move Index is a measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility. ICE® is a registered trademark of ice data or its affiliates, and bofa® is a registered trademark of Bank of America corporation.

CBOE Volatility Index is a real time index that represents the market's expectations for the relative strength of near-term price changes of the S&P 500 Index.