COLUMBIA THREADNEEDLE INVESTMENTS

It's a record: More people than ever are betting that rates will rise

May 16, 2018

The popular use of fixed-income derivatives is allowing investors to aggressively bet that interest rates will rise. But what if they're wrong?

Gene Tannuzzo
Senior Portfolio Manager

Derivatives are a popular way for professional investors to manage duration.

A bond's duration indicates how sensitive it is to changes in interest rates — the longer the duration, the higher the sensitivity. So when investors expect rates to rise (as many people do right now), they aim for a shorter duration bond portfolio.

There are three options to manage duration in a bond portfolio:

1. You can buy bonds that correspond with how long you want your duration to be. For example, if you're targeting a three-year duration, you can purchase bonds with a corresponding maturity.
2. You can buy a collection of bonds that *average* your overall duration target.

These first two are viable options, but they limit your bond universe. And if you want to change the duration at any time, you have to sell or buy bonds, which may take up to a few days to settle. That's why so many professional investors opt for the third option:

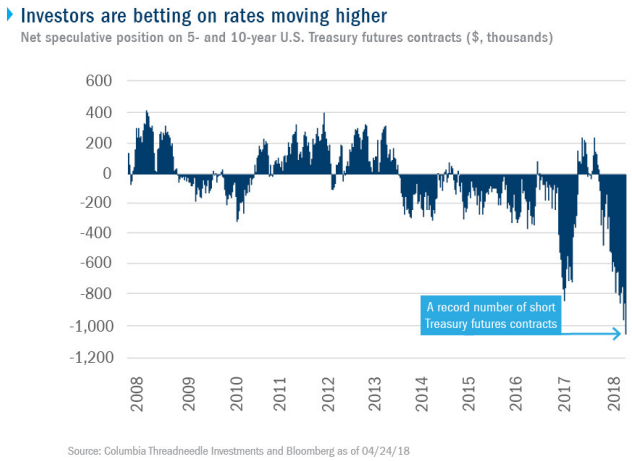
3. You can buy any bond you want and then use Treasury derivatives to adjust your overall duration.

Derivatives allow professional investors to adjust the portfolio's duration up or down almost instantly.

A herd mentality on interest rates is creating a crowded trade.

Last March, we hit a record number of investors using derivatives to shorten duration. But this year, we beat that record. The near-universal expectation that interest rates will rise has contributed to this record setting use of derivatives as investors short (or sell) Treasury futures contracts to adjust their portfolio duration down.

A **derivative** is a contract that takes — or derives — its value from the price of underlying assets, such as an index or a specific security. Derivatives are typically used by professional investors as part of a risk management strategy or as a bet on an asset's future price.



Some investors may get caught on the wrong side.

But there is a risk: If interest rates don't rise the way the herd expects them to, investors will have to change or cover their position. In this instance they'll have to buy back Treasury futures contracts. If you get enough people doing this all at the same time (in this case, a potentially record number), this will create a lot of demand for Treasury futures all at once, and that demand will drive the price up higher and higher as more people try to buy, which will in turn cause yields to fall. Investors will find themselves having to buy Treasury futures at a higher price instead of a lower one. This feedback loop creates an acceleration in the opposite direction of what they were positioned for: They were trying to position for falling prices and rising yields, but they find themselves paying higher prices and their yields falling at an accelerated rate.

We estimate that based on current positioning, an investor who has shortened duration by one year using a 10-year Treasuries futures contract stands to lose 1.54% if rates fall by 0.25% and lose 3.09% if rates fall by 0.50%.[1]

Are derivatives hiding risk in your bond portfolio?

Watch Gene Tannuzzo discuss the opportunities and risks in this one-minute video.

The economy continues to expand, but if the economic data fails to live up to everyone's elevated expectations it won't take much to shake their confidence, quickly lower their currently very high expectations, and trigger this feedback loop. We think there are a few factors lining up that could lead to this. For example, we recently saw the Citi European Economic Surprise Index, which is a measure of whether economic data is living up to expectations, take a big fall. As another example, the Purchasers Manufacturing Index climbed to 60 in February, which may be unrealistically high to maintain and sets it up for a fall. Arguably, U.S. economic data reaching these highs in early 2018 may have caused expectations to reset even higher. This isn't to say growth isn't good (as Jeff Knight, Global Head of Asset Allocation recently wrote there is economic growth around the world and we don't expect a recession this year), just that expectations may be exceptionally high and it won't take a lot to shake people's confidence.

In fact, it may be time for investors to exit the duration bunker. From September 2017 to April 2018, rates on the 10-year Treasury have gone from just over two to almost three — nearly a-100 basis point increase. So the time to be fearful and defensive on duration was at least six months ago. If rates continue to increase, the next step is likely to be smaller and less worrisome for investors.

COLUMBIA THREADNEEDLE INVESTMENTS

Bottom line

Fixed-income portfolios that are using a significant amount of derivatives to aggressively manage duration may be exposed to an unintended risk as everyone makes the same bet. And remember, Treasury yields are already meaningfully higher than even just a short time ago. It may be time to begin increasing duration.

[1] Source: Columbia Threadneedle Investments as of 05/11/18.

The Citi Economic Surprise Index measures, on balance, how much economic data releases have beaten consensus estimates.

The Purchasing Managers Index surveys purchasing managers and serves as an indicator of the economic health of the manufacturing sector.

To find out more, call 800.426.3750
or visit columbiathreadneedleus.com

Not FDIC insured • No bank guarantee • May lose value

Securities products offered through Columbia Management Investment Distributors, Inc., member FINRA. Advisory services provided by Columbia Management Investment Advisers, LLC.

Columbia Threadneedle Investments (Columbia Threadneedle) is the global brand name of the Columbia and Threadneedle group of companies.

The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Management Investment Advisers, LLC (CMIA) associates or affiliates. Actual investments or investment decisions made by CMIA and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be suitable for all investors. Past performance does not guarantee future results, and no forecast should be considered a guarantee either. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that any forecasts are accurate.

CTBPBZR1 (5/18) 2120973