Jennison Associates
Clipping Coupons: You Had Me at Duration
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Audio starts

Alex: [00:00:00] Welcome back to Clipping Coupons with Jenison Fixed Income. My name is Alex Chansky, and I'll be your host for the show. Today I have with me Sam Kaplan, who's a portfolio manager here at Jenison Associates, and he focuses mostly on rates. .

Sam, how are you doing today?

Sam: I'm doing great. Thanks for having me.

Alex: So Sam, thanks a bunch again for coming on. can you tell me briefly about kinda your role here at Jenison and maybe how long you've been here?

Sam: Sure. So I started at Jenison 17 years ago, March of 2008. The day that I started was a, a Monday. It was actually the day after, Bear was officially sold to JP Morgan. So lots of volatility in the markets. We might be starting to see something similar right now with policy uncertainty. from the change in regime and change in government, it seems like a lot of volatility happens in March.

if you remember, March of 2020 was Covid So maybe not as much volatility as we saw during those two periods, but definitely, uh, signs of an increase in volatility. Anyway, I started my career as a trader, trading, rates, and then was promoted portfolio manager in 2016 and have been the lead rates decision maker since, uh, 2023.

Okay, so then one, fun question to start you off here. I heard you don't support any Boston sports teams. Yeah. Well, I don't think I would ever would've been a Boston Sports fan having grown up in New York. My, family is actually diehard New York sports fans through the Knicks, the Rangers, the Mets, and the Giants. When I was 12 years old, I guess I decided I wanted to be different. I started to follow teams based on players that I liked, thought were cool.

So I am an Atlanta Falcons fan, for football. I am a Chicago White Sox fan in baseball. I'm a Golden State Warriors fan in basketball, and I am a St. Louis Blues fan in hockey. very eclectic group. Yeah.

Alex: Really all corners of the country.

Sam: All corners of the country.

Except the one we live in,

Except the one I grew up in and the one that I live in currently.

Sam: actually being in Boston since 2005, 20 years now, I've had a lot of success with my sports teams against Boston teams. The Warriors just won a championship against the Celtics a couple years ago. the

Blues won their only Stanley Cup against the Bruins, and I actually went to two of the, the Stanley Cup finals games here in Boston.

I almost got beat up a couple times, but it was fun to be there. even in 2005 when I moved up here, the White Sox beat the Red Sox in the first round of the playoffs before going on to win the World Series. That being said, the one I guess moment that really causes me a lot of pain is the Falcons blowing that 28 3 lead against the Patriots in the Super Bowl.

I think I'd give up all the titles for the other teams just to have that Super Bowl back. Being in New England and then hearing about 28-3 over and over again, just causes me pain. and that's the only team of mine that hasn't won a championship, so it makes it that much worse that they blew such a big lead and are known for having the largest blown lead in a Super Bowl.

And the Falcons haven't [00:03:00] sniffed the Super Bowl since.

So I don't know if it's the curse of 28-3 or, or whatnot. But, maybe we'll start to turn things around next season. We'll see.

Alex: Great. All right. Awesome.

Yeah, so let's get into the serious questions here then. Very serious podcast over here.

the yield curve is something you work with every day. It's, if I understand it right, It's basically a graph showing yields of different treasuries if they're held to maturity. And normally the yield curve is supposed to show that Treasuries with longer maturity dates have higher yields.

Can you tell me a little bit more about that and maybe what it means for the yield curve to be inverted?

Sam: Yeah, that, that's right, Alex. So, a normal shaped yield curve is upward sloping. Basically, if you lend your money for a longer period of time, you want to have a higher return to compensate for that risk of not getting paid back potentially, or just having your money locked up for or away for a longer period of time.

So on the X axis of a graph, you would have the maturity point going from one month all the way out to 30 years. And on the Y axis you would have the yield of those bonds. And typically the further out you go, the higher yielding that security would be. During certain periods of time, the yield curve inverts, and that basically means that longer duration securities, longer tenor securities are yielding less than shorter duration securities.

That can happen for a multitude of reasons. Most recently, it happened in starting in 2022 because the Fed was hiking rates at the front end aggressively. they hiked rates by 75 basis points four different times in 2022. They brought rates from the zero lower bound all the way up to between five and a quarter and five 50 very quickly over the span of less than a year.

and the market priced in that eventually those rates would cause the economy to soften, to slow, potentially even go into recession, and that ultimately the Fed would then need to lower rates back towards a more neutral rate, and as a result, the market priced in lower rates further out the curve.

Historically, an inverted curve is a signal of potential recession. There's talk now that the curve has dis inverted, that maybe it was a false indicator of recession, as the economy is still going strong. I happen to think that we're not necessarily out of the woods yet as the inverted yield curve being a signal of recession.

I mean, 2s 10s was inverted for a record, 783 days that broke the previous record of 624 days. 2s 10s is the yield difference between the two year treasury and the 10 year treasury. So the two year treasury yielded more than the 10 year treasury for a record, 783 days.

The market looks at that as a recessionary indicator. I happen to think, and other investors in the market happen to think that the three month, 10 year point is a better indicator of recession. That has a better historical record of signaling recession, and it has happened where three month tenure, the three month bill versus the 10 year treasury has inverted every single time before recession since 1960, there's only been one false positive where the curve inverted and we didn't [00:06:00] get a recession shortly thereafter.

And while twos tens is now significantly positively sloped, it's north of 30 basis points today. Three month Ten Year is hovering right around even yield, bouncing back and forth between inversion and dis-inversion. you couple that, with the fact that, Atlanta, GDP now is showing a negative GDP print for Q1 of this year, in addition to a lot of policy uncertainty from the new government with on again, off again, tariffs.

With them talking about that we might need to have a recession or a slowdown to reset that sort of order. the fact that with these tariffs, with the strife that is it's causing with allies, there's a lot less demand for US products. There's a lot less demand to travel to the us.
I certainly don't think we are out of the woods of a potential recession happening. It might not happen. the curve could be a false indication this time. But given the fact that, we have a lot of uncertainty right now and the fact that the economy is starting to soften and slow, you also have stock markets reflecting that uncertainty and that risk with some markets being in correction territory, some even entering a bear market, if that wealth effect were to continue, if stocks were to continue selling off.

It could lead to that recession that people have been calling for for a long time.

Alex: I guess the other thing I would add as far as Jenison and our positioning, even though part of the reason why investors are so interested in.

Sam: Whether or not a recession is going to happen is what that means for monetary policy and the Fed. Historically, when there have been recessions, the Fed has come to the rescue, reduced rates aggressively in the front end, and the yield curve has steepened dramatically. We've been in a yield curve steeper for a while now, even though you haven't had recessionary data, even though you've had the Fed only cut rates by a hundred basis points from the peak and not aggressive easing like you've seen in past cycles when you've had that recession, the yield curve still has steepened out pretty dramatically. In July of 23 twos, tens was inverted by a hundred basis points. As I mentioned, as we sit here today, we're positively sloped between 30 and 40 basis points, sort of chopping around there for the past month or so.

So the curve in a year and a half's time or a year and three quarters time has steepened the 130, 140 basis points. We've been able to reduce the negative carry while we wait for the trade to work. We've been able to tactically trade the position around as you've gotten curve volatility with the Fed is gonna cut aggressively.

The Fed is not gonna cut aggressively. And so we've been able to add performance, add Alpha in our portfolios being an yield curve steeper, despite the fact that we haven't gotten that recession, that aggressive fed easing, which might still happen down the road and lead to further steepening of the curve.

Alex: Thanks so much. And just to clarify, negative carry, in, in layman's terms, is that basically the cost that we pay to kind of hold a position over a period of time? Is that right?

Sam: Sure. So certain positions are negative carry, certain positions are positive carry. If, if you position the [00:09:00] portfolio to have a higher yield than your benchmark, you, you have positive carry.

If nothing happens in the market, if nothing changes, you're gonna outperform because you have additional yield. Versus that benchmark, a negative carry position just means that you have less yield in your portfolio than the benchmark. You also potentially have less roll down or you have roll up that can affect you negatively.

so being in a yield curve steeper when the curve was inverted, was negative carry and heavily negative carry at some points, because you sell the 10 year and you buy the two year, and yes, you're picking up yield, but if the one year to two year point is more inverted, then the two year to 10 year point is you're, you're giving up yield because in order to get the same amount of duration to own that two year security, you have to buy four times the amount that you would do of the 10 year.

So you might pick at its peak and 2 cents was inverted by a hundred basis points. You're picking a hundred basis points on, say, a hundred million of the trade, but then on the other 300 million, if you're giving up 50, 75 basis points, you're giving up yield in total. on at the portfolio level.

Alex: Thanks so much. So then the next question here, based on your understanding, would you say that we are in an environment with interest rates that are gonna be kind of held higher for longer at this point?

and if so, what may be the implications for fixed income markets?

Sam: For a large portion of, of investors who began their career after the global financial crisis, this certainly is considered a high yield environment or a high rate environment because of the amount of stimulus from monetary policy where the Fed held rates low at the zero lower bound for an extended period of time.

But others who started their career prior to the global financial crisis. I think they would just consider this yield environment normal for some people who've been in the market since the late seventies, early eighties, this is actually a low yield environment. 'cause rates got to double digits, due to the heavy inflation that we saw back in, in in that time period.

It's hard to say where rates are gonna go from here. I think in any environment, it's hard to say where rates are gonna go. Jenison doesn't take duration positions versus their benchmarks for that reason. We don't think that the level of rates mean reverts, and if it does, it's certainly an extended cycle.

We were in a bond bull market for multiple decades prior to 2022 when rates started to move higher. Prior to that, in the late seventies, early eighties, we were in a bond bearer market for multiple decades. So where the level of rates goes from here is anyone's guess. There's lots of factors that are pushing and pulling rates that can determine if we're gonna continue to move higher or go back to a sort of lower rate environment like we've been in for the last decade plus.

From a monetary policy perspective, I think central banks around the world are coming to the realization that. Being at the zero lower bound, or even negative rates in other countries, was probably a mistake. And we're dealing with the repercussions of that now and the increased inflation that we've seen coming out of the pandemic and [00:12:00] the inability of the Fed and other central banks to get back to their target inflation in a more timely manner, even though they have raised rates pretty aggressively.

So I think it would be hard for us to go back to that extreme level of rates anytime soon. That being said, if we were to get a recession, if we were to get a, a quick downdraft in risky assets in the stock market, I don't think the fed put is gone. I do think the Fed will cut rates aggressively and move to a easy monetary policy.

The level of neutral is up for debate. The Fed used to say it was sort of mid twos, estimates of, of neutral have been increasing over the last couple years to the high twos, to the low threes. I don't think the Fed will cut all the way down to zero. Again, I think quantitative easing hopefully is something that we will not need or see.

Again. That being said, I think the Fed could cut rates down to 1%, 1.5% if we get, a recession and, get a market in an environment where that is necessary to stimulate the economy. So if this continued softening of the economic data continues, if stocks continue to sell off and layoffs start to happen and the unemployment rates spikes, I think rates will go lower from here, at least in the short term If we're able to.

Change the world order without having any kind of serious economic consequences here in the us, rates could stay at these levels or maybe even move higher. You have a increased deficit here in the US You have an administration that's intent on, extending tax cuts and while they're trying to cut spending, a lot of the programs where they would need to cut spending to seriously reduce the deficit would get a lot of pushback.

And so if you continue to see increased, increased deficits here in the us, that means increased supply of treasuries. You will have, as I mentioned, allies who are starting to get frustrated with the US a lot of foreign holders of US treasury securities who might go on a buyer strike, and the level of yields can certainly move higher, especially in the long end of the market where the Fed isn't controlling short end rates by setting monetary policy.

So. there's a lot of factors at work that, as I mentioned, push and pull the level of rates. I think a lot is truly gonna depend on what happens with the economy, what happens with the data, what happens as far as which factors went out. Because you have deglobalization, which seems to be happening at a rapid rate.

You have an aging and declining supply of labor. Both of those things are inflationary. On the flip side, you have a Fed who is still doing quantitative tightening and reducing the money supply. You have increased productivity from ai. Those are both deflationary, and so again, you have this tug of war, this push and pull of what is going to win out, and that is gonna [00:15:00] decide the level of rates over time.

I don't think we can call, which is going to be the winner and which direction rates it's gonna go. and as a result, part of our philosophy is to just be duration neutral versus our benchmark.

Alex: Got it. Okay. Yeah, that's a perfect answer. I think that segues in really nicely to the next question I have here.

if you can tell us a little bit about where you maybe do see value on the yield curve and how we try to take advantage of that in some of our portfolios.

Sam: So at times we have directional views on the curve. When the curve is historically flat or inverted, we're looking for opportunities to put on a yield curve steepener. When the curve is historically steep, we're looking for opportunities to put on a yield curve flattener. That being said, there's not always going to be a view on the direction of the curve, whether we think the curve is gonna steepen or flatten. Or we might be at levels where we could go either way and the risk reward is not that attractive to having a directional trade. We are constantly looking for relative value opportunities outside of just having that directional view right now. We think that there are two opportunities, still on the yield curve from a relative value perspective that offer value.

One of those relative value opportunities is owning the 20 year part of the treasury curve. In 2020, the treasury reintroduced 20 year issuance. For the first time in decades, as supply was increased across the curve, they disproportionately increased the 20 year part of the curve. as far as the amount of supply that was happening to where it far superseded the demand, and as a result, the 20 year point dislocated from the rest of the curve and got very cheap. You could sell the 10 year treasury to buy the 20 year treasury at one point and pick almost 60 basis points, and at the same time, you could sell the 30 year treasury to buy the 20 year treasury and pick 20 to 30 basis points.

So it really stuck out on the curve as a cheap point. Because of that, that glut of supply and that liquidity.

While the 20 year has recovered significantly over the course of the past couple years, since middle of 2022, it's been a one way trade where the 20 year has outperformed, we still think it offers some value. We've owned the 20 year part of the curve since late 2021. We're a little bit early getting in, added to the position until middle of 2022, and then have ridden the trade for the last couple years.

We've reduced our position over time as the 20 year has richened up. But as we sit here today, the 20 year still is higher yielding than both the 10 year and the 30 year. You still can pick yield to do that butterfly trade. So we still think that it offers value. the other trade that we like.

Especially in our strip accounts is to own coupon strips versus principle strips. The spread between principles and coupons, which are the same cash flow, the same date maturity is historically wide, especially in that 15 to 20 year part of the curve where the spread [00:18:00] between those similar cash, same cash flows is anywhere from 20 to 30 basis points.
So you have a 30 year bond. Let's say it's a generic 30 year bond with a 5% coupon. Someone wants to go and buy just that principal cash flow where I'm gonna give you money now and in 30 years time, you're gonna give me that payment back for the amount of principle. When that happens, dealers strip.

Coupon bond into their components, the principle that's due in 30 years, and then the coupon for every six months going out, that entire 30 year stream. And what we've seen recently in this higher rate environment is a large demand for long end peas, which has led to a large supply of coupons being created across the curve.

And when the end user buys those Ps, the bank or the dealer that strips the bond is left with those coupons on their balance sheet and has to find a buyer for them. And in order to find buyers, they've consistently cheapened up those coupon strips so that the coupon spread versus the P has widened materially.

We have over the past couple years went from not owning any coupon strips in our strip portfolios to owning. A lot of them. And having a large overweight, as those bonds have continued to widen out, it hasn't hurt us in far as performance because of that excess spread and excess yield that we're picking up.

And more recently, because of deregulation stories, coupons have started to tighten back in and we've started to get performance from them as well. So we continue to like that trade. We've actually started to buy coupon strips. In the front end of the curve in our shorter portfolios where there's lots of treasuries in the benchmark because we're able to pick 10 to 15 basis points for a coupon versus a similar maturity coupon bond.

and we don't necessarily need that liquidity because the benchmark has 50, 60, 70% treasuries in it. So we're always gonna own treasuries. So if we can just pick up that excess spread, that excess yield, just because we're giving up a little bit of liquidity. We're willing to do that right now, given the historically wide levels.

Alex: Great. Thanks so much, Sam. And then the last question I have on here is another fun one if you have a, favorite book or movie or TV show, something you've, come across recently that you wanna share with everyone.

Sam: Typically, I read a lot of, spy thrillers to sort of escape and get my mind away from thinking. favorite authors are Vince Flynn, Daniel Silva, Dan Brown. Steve Berry, David Baldacci. but from time to time, I, I try and read books that are also educational and I think will help me out as far as being a person and also in my career.

A book that I'm reading right now, and I'm about halfway through is called Think Again by Adam Grant. and I guess the lesson that he wants people to learn is the importance of mental flexibility. and [00:21:00] the ability to sort of rethink one's positions, rethink one's beliefs and opinions to accept new information, and have curiosity.

And to understand that what you think or, or what you, your view is, might be wrong and might be proven false. I think that would help a lot of people in this world, in this current environment. but I think it also will help me as a portfolio manager, as far as the positions that we have in our portfolios.
As far as being able to think that, my view last week, my view last month might be different now, maybe it should change because we've gotten a lot of new information and in this environment where there's new headlines every day, there's lots of volatility.

I think a good portfolio manager, a good decision maker, really does need to be flexible right now. and be able to rethink one's views and one's positions and change, on a dime. should new information prove an old view false. So, hopefully it will allow me to be better, at rethinking my views, re-looking at my views and whether or not the thesis still holds and whether or not our positioning should stay the same, or we should shift positioning based on new information.

Alex: Perfect. Thank you so much, Sam.

Sam: Thank you for having me and, I hope everyone enjoys listening to clipping coupons.

Alex: Appreciate it. Thanks again, Sam.

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