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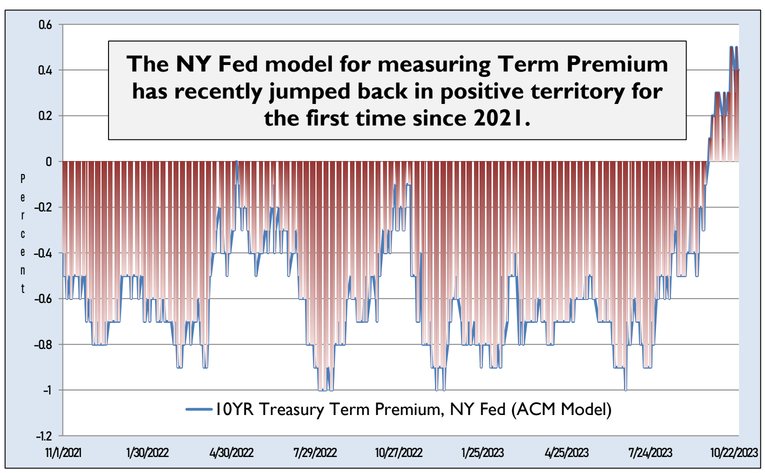
Term Premium Makes a Comeback

In recent weeks, the longer end of the bond market has suffered from sharply rising yields. Some fraction of the weakness can be properly attributed to the bond market's taking away aggressive estimates about the Fed's cutting interest rates in 2024 and 2025. And we would agree with that: our view has long been that the economy would be stronger than expected; that recession fears as caused by raising interest rates were too high; and that the interest rate cuts priced into the market were too ambitious.

However, another phenomenon is also at play: the Term Premium. In its simplest terms, the Term Premium is the extra yield bond investors get for owning longer-term bonds compared to owning and rolling over short-term bonds.



That is, a fixed income investor with a two-year horizon can either just buy a two-year Treasury bond…..or he/she can buy a one-year Treasury bond, hold it for a year, and then buy another one-year Treasury bond at that time. If the yield on the one-year bond is 4% but the yield on the two-year bond is 5%, then as long as the yield on the one-year bond in one year from now is less than 6%, then the investor will collect extra yield for taking the risk of owning the two-year bond in the first place. This is called the Term Premium. Estimating the Term Premium can be fiendishly more difficult than the simple example above **(see the NY Fed's ACM model at center)**, but the simple point to remember is that the Term Premium had been negative (i.e., bond investors were paying to take more risk) and only just recently it has turned positive (i.e. bond investors now get paid to take more risk).

What accounted for the negative Term Premium, and what is the outlook today?

There are many guesses on the first question, but answers center on the following thesis: when the Fed was buying huge amounts of bonds under its Quantitative Easing program, it effectively was capping any upside rise in interest rates and thereby decreasing bond yield and price volatility. On the other side of the equation, bond yields were considered to have a floor near 0%, because investors can always take their money if yields turn negative and put that money under the mattress, literally or figuratively. With volatility on both the upside and downside limited, some investors may have concluded that longer-term bonds were not so risky, and they may have accepted a low or even negative Term Premium. The argument gathers further strength when we consider bond traders with short-term horizons who may have simply concluded that the Fed was a forced buyer at any price or at any Term Premium, and so it was acceptable to buy ahead or alongside the Fed.

However, those conditions have now changed, and so has the Term Premium, which is now positive, albeit still below historical levels. Therefore, today's important question is whether the Term Premium will revert to its recent history of being negative or whether it will continue to rise. As our wording above suggests, we don't see the Term Premium turning negative unless the conditions from a few years ago resurface, and we do not believe the Fed will be a significant buyer of bonds again unless there is a market disruption that causes it to need to step in.

Could the Term Premium continue to rise?

It could. The Term Premium is positively linked with interest rates, which have risen. Investors are also focused on factors such as the rising supply of government debt needing to be financed because of omnipresent federal budget deficits. The presence of a price-insensitive forced buyer in the bond markets has been replaced with the presence of a forced seller.

It is important to pause and remember that the Term Premium is the extra yield investors get for taking extra risk. So, theoretically, it can rise and elevate bond yields and depress bond prices even if other factors such as inflation expectations and predictions about Fed policy moves remain perfectly unchanged. In the 1970s, bond investors demanded a huge Term Premium to compensate themselves. Remember how this was a period of energy shocks, unanticipated but constantly rising inflation and deteriorating United States finances. We at Northeast do believe that the bond market has become more attractive as yields have risen. And we retain our optimistic view on the economic outlook in terms of employment, corporate profits and the like. We scratched our head a bit when the Term Premium was negative in recent years, long believing that anomoly would come to an end. That has happened, in part but perhaps not fully. **Accordingly, we continue think value exists in the high yield market, with its short duration compared to other classes and with the extra yield available from owning corporate bonds.**

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeast Investors Trust for more than 30 years.

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