5 Reasons to Consider Short Duration Credit

January 2023

The potential for higher yields and protection from volatility make a compelling case for short duration bonds

1. Potential for Compelling Risk Reward

Yields rose significantly in 2022 on a global basis, primarily driven by rising interest rates, a reduction of liquidity as central banks withdraw stimulus, and spread widening. Some of the largest moves were in short duration bonds. While we have seen a significant rally in the first few weeks of 2023, driven by more dovish central bank rhetoric and falling inflationary pressures, short duration yields remain compelling. At the short end, we believe investors can access yields of c. 4.5% in investment grade and c. 8-9% in high yield (Figs. 1 & 2), while bonds further out the curve are offering a similar yield with more risk.

2. Low Credit Risk

Short-dated bonds are deemed less risky than their longer-dated counterparts, given their greater likelihood of repayment. For investors concerned about increasing recession risks, and the potential for higher default, investment grade bonds have historically had a relatively low default risk (0.14%)\(^1\) and we expect the sub-asset class to remain insulated from growing credit risks, although credit quality remains key.

We also believe there is currently too much default risk being priced into high yield. The implied BB-B default rates are currently higher than the 2008/2009 realised rates. Global employment data continues to be strong, and we are also seeing supportive fiscal measures in the US and Europe plus the reopening of China after the reversal of its Covid-zero policy.

Within both sub-asset classes, we see the best opportunities in BBB and BB rated credits, where in-depth fundamental analysis can identify bonds with the potential for compelling carry in companies able to meet their debt obligations under a variety of economic scenarios.

\(^1\)Moody’s, as of 31st December 2021. Updated annually. Latest data available used

Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested. Past performance is not a reliable indicator of current or future results.
3. Low Volatility

Short-dated bonds of creditworthy companies tend to display less price volatility than their longer-dated counterparts. They rarely trade below par but if they do they tend to reverse quickly and converge back to par as the bond approaches maturity - the ‘pull-to-par’ effect. This also helps short-dated bonds recover from drawdowns. Should we experience future periods of volatility, investors at the short end will therefore be less affected than they would in longer-duration instruments.

Source: ICE Data Platform, ICE BofA 0-3 Year Duration-To-Worst BB-B Cash Pay US High Yield Constrained Index (J4CS), as of 18 January 2023. For illustrative purposes only. Index has been used as the best proxy for short duration US high yield.
4. **Less Interest Rate Risk**

In our view, many market participants believe inflation may have peaked, which would in turn indicate central banks culminate their hiking cycles around the middle of 2023 (Fig. 5). However, we feel central banks will need to see a sustained decline in inflation before rate hikes come to an end and rate cuts take over, and it may take some time for inflation to fall.

In our view, inflation may remain at c. 3-4% for longer-than-expected given underlying structural issues such as labour shortages and changes in supply chains. We do not believe this is currently priced in and, if rates stay higher for longer the curve will steepen and the long end will underperform while shorter duration instruments hold up well. In the interim, short duration bond yields benefit from the inversion of the yield curve, a rare event.

Fig. 5 - US Interest Rates Priced to Peak at 5% in Mid 2023

Source: Bloomberg data as of January 10th, 2023. Bloomberg World Interest Rate Probability (WIRP). For illustrative purposes only.

5. **Reinvestment Opportunities / Lower Reinvestment Risk**

Short duration high yield and investment grade bonds may have different repayment structures. Investment grade bonds typically trade to maturity; a portfolio of these bonds therefore has a steady cash flow from maturities that can be used in the primary market. High yield bonds may be callable, allowing companies to repay bonds before maturity. However, if the cost of funding increases, a company may leave their bond outstanding. Therefore, an investor may benefit from the higher carry in the existing bond while avoiding the issue of finding reinvestment opportunities if there is limited primary supply.

**Conclusion**

Based on current prices, in our opinion corporate credit offers a compelling investment opportunity and we aim to capture the best quality of return in the short end within BBB and BB rated bonds. At these levels, prices below par offset the impact of potential credit losses, with the possibility of good carry, good convexity, lower credit and duration risk and a strong pull to par at the short end of the market.

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