Short Duration Credit – Consensus Should Not Drive Conviction

April 2023

In times of uncertainty, we believe it makes sense to optimise return potential across a range of possible outcomes, rather than maximise it based on a particular scenario.

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.

From today’s starting point, we believe a wide range of economic and investment outcomes is possible for the rest of 2023. Bouts of volatility are likely to punctuate a year in which central banks must balance their fight against inflation with recessionary risks associated with tighter financial and lending conditions.

Anticipation of a traditional rate curve cycle and growing fears of a looming recession have encouraged investors to consider extending duration in their fixed income allocation. Moving out along the rates curve positions investors for greater total returns from a fall in interest rates, should central banks turn to looser monetary policy through the end of 2023 and 2024.

As the success of this strategy is largely dependent on interest rates falling, we feel it is important that investors are aware of other opportunities that may succeed in a broader range of scenarios. There are risks from positioning in longer-dated fixed income as evidenced in 2022. Whilst the range of outcomes suggests returns could be maximised with longer duration, we don’t believe they are optimised from a risk perspective. Investors must remain critical of consensus positioning and what appears to be the obvious next trade.

Starting Yields

Let’s start by looking at the yields available in credit, particularly in investment grade where duration positioning is most prevalent. Inverted rate curves, coupled with upwardly sloping spread curves, combine to give notably flat yield curves in both the US and Europe. This tells us that, should yield curves remain unchanged over the next 12 months, you could generate a similar return from credit across the duration spectrum. Thus, an investment in longer-dated credit needs to be justified by a view that interest rates will move lower over the investment period, driving potential for a greater total return from longer-dated bonds.

Fig. 1 - Investment Grade Yield to Worst by Duration

Source: ICE Data Platform, as of 20th April, 2023. All data in local currency. ICE 1-3 Year US Corporate Index (C1A0), The ICE BofA ML 3-5 Year US Corporate Index (C2A0), ICE BofA 5-7 Year US Corporate Index (C3A0), ICE BofA 7-10 Year US Corporate Index (C4A0), ICE BofA 10+ Year US Corporate Index (C9A0), ICE BofA ML 1-3 Year Euro Corporate Index (ER01), ICE BofA ML 3-5 Year Euro Corporate Index (ER02), ICE BofA 5-7 Year Euro Corporate Index (ER03), ICE BofA 7-10 Year Euro Corporate Index (ER04), ICE BofA 10+ Year Euro Corporate Index (ER09). For illustrative purposes only. Indices used are best representation of the market.
Yield Break-Evens

Given the ongoing upside and downside risks in the economic and monetary policy outlook we must also consider the return outcomes should the consensus interest rate view be wrong. Mixed economic data coupled with changing central bank messaging continue to make the economic and policy outlook unclear. Indeed, a more cautious approach to monetary policy tightening and an extended policy and credit cycle could leave a duration extension trade looking premature.

In this scenario we can consider what yield moves an investor can tolerate at different points on the yield curve before suffering negative returns over a 12-month period. In Figure 2 we present these yield ‘break-evens’ in investment grade markets. These show the approximate changes in yield required to generate a negative return over the coming 12 months.

Fig. 2 - Investment Grade Yield ‘Break-Evens’ by Duration

Source: ICE Data Platform, as of 20th April, 2023. All data in local currency. ICE BofA AAA US Corporate Index (C0A1), The ICE BofA ML 3-5 Year US Corporate Index (C2A0), ICE BofA 5-7 Year US Corporate Index (C3A0), ICE BofA 7-10 Year US Corporate Index (C4A0), ICE BofA 10+ Year US Corporate Index (C9A0), ICE BofA ML 1-3 Year Euro Corporate Index (ER01), ICE BofA ML 3-5 Year Euro Corporate Index (ER02), ICE BofA 5-7 Year Euro Corporate Index (ER03), ICE BofA 7-10 Year Euro Corporate Index (ER04), ICE BofA 10+ Year Euro Corporate Index (ER09). For illustrative purposes only. Indices used are best representation of the market.

Yield ‘break-evens’ are highest in short-dated bonds, with the largest increase in yields required before expected returns turn negative. The further out one invests, the less room there is for error with ‘break-evens’ of just 30 to 80 bps in duration longer than 7 years. This appears modest given that the US 10-year Treasury yield has moved in a 75bp range already this year, and in an almost 95bp range since October 2022.

It is therefore clear that speculation plays a larger role in the investment thesis in longer-dated credit, and room for error is more limited.

Pull-to-Par and Volatility

On the other hand, simple bond mechanics play a larger and more favourable role in your return potential in short-dated bonds. The average price of bonds in a global short-dated investment grade index was approximately 96 at the end of March 2023, with less than 2 years to maturity on average. These conditions are relatively unusual (Fig. 3). Assuming defaults are avoided, there is a mechanical component of bond investing that will take these bonds back to par over the remainder of their life. This is unlikely to be without volatility and we should not expect a straight-line appreciation, but volatility should be significantly lower than in longer-dated bonds.
Fig. 3 - Average Price of Short-Dated Bonds Over Time

Source: ICE Data Platform, as of 31st March 2023. ICE BofA 1-3 Year Global Corporate Index (G1BC) For illustrative purposes only. Index used is best representation of the market.

Greater Visibility of Repayment

We must at the same time respect that this pull-to-par argument assumes defaults and credit losses are avoided. Indeed, this mechanical element of return would be undermined if the issuer was unable to honour an instrument’s repayment at maturity. However, investors in short-dated bonds also have the benefit of far greater visibility regarding repayment options for short-dated maturities. Analysis can identify cash on balance sheet, free cash flow generation, credit lines or options available in credit and equity markets to ensure repayment at maturity. Furthermore, a portfolio’s higher-quality bias would typically imply more exposure to companies with cash available to repay short-dated debt, simplifying this assessment further.

Summary

In summary, we do not believe that the risk-reward in longer duration credit appears favourable in the current market environment. We acknowledge the appeal of longer-dated investments but continue to prefer the shorter-dated part of the market for its comparable yields, more forgiving ‘break-evens’, and the mechanical element of potential returns that comes from low cash prices and the ‘pull-to-par’ effect.

The merit of this view is further enforced by the potential for an extended market cycle, where we could see market interest rates remaining volatile or even drifting higher as we avoid the immediate crisis that the Silicon Valley Bank and Credit Suisse events encouraged the market to anticipate.

Risk: Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and should not be construed as investment advice or investment recommendation of those companies.
Index Descriptions

C1A0 - ICE 1-3 Year US Corporate Index is a subset of the ICE BofA US Corporate Index (C0A0) including all securities with a remaining term to final maturity greater than or equal to 1 year and less than 3 years.

C2A0 - The ICE BofA 3-5 Year US Corporate Index is a subset of the ICE BofA US Corporate Index (C0A0) including all securities with a remaining term to final maturity greater than or equal to 3 years and less than 5 years.

C3A0 - ICE BofA 5-7 Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

C4A0 - ICE BofA 7-10 Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

C9A0 - ICE BofA 10+ Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 10 years.

ER01 - The ICE BofA 1-3 Year Euro Corporate Index is a subset of ICE BofA ML Euro Corporate Index (ER00) including all securities with a remaining term to maturity less than 3 years.

ER02 - ICE BofA 3-5 Year Euro Corporate Index is a subset of ICE BofA ML Euro Corporate Index (ER00) including all securities with a remaining term to final maturity greater than or equal to 3 years and less than 5 years.

ER03 - ICE BofA 5-7 Year Euro Corporate Index is a subset of ICE BofA Euro Corporate Index including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

ER04 - ICE BofA 7-10 Year Euro Corporate Index is a subset of ICE BofA Euro Corporate Index including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

ER09 - ICE BofA 10+ Year Euro Corporate Index is a subset of ICE BofA Euro Corporate Index including all securities with a remaining term to final maturity greater than or equal to 10 years.

G1BC - ICE BofA 1-3 Year Global Corporate Index is a subset of ICE BofA Global Corporate Index including all securities with a remaining term to final maturity less than 3 years.

Important Information

Muzinich and/or Muzinich & Co. referenced herein is defined as Muzinich & Co., Inc. and its affiliates. Muzinich views and opinions. This material has been produced for information purposes only and as such the views contained herein are not to be taken as investment advice. Opinions are as of date of publication and are subject to change without reference or notification to you. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Rates of exchange may cause the value of investments to rise or fall. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity.

Any research in this document has been obtained and may have been acted on by Muzinich for its own purpose. The results of such research are being made available for information purposes and no assurances are made as to their accuracy. Opinions and statements of financial market trends that are based on market conditions constitute our judgment and this judgment may prove to be wrong. The views and opinions expressed should not be construed as an offer to buy or sell or invitation to engage in any investment activity, they are for information purposes only.

This discussion material contains forward-looking statements, which give current expectations of a fund’s future activities and future performance. Any or all forward-looking statements in this material may turn out to be incorrect. They can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Although the assumptions underlying the forward-looking statements contained herein are believed to be reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurances that the forward-looking statements included in this discussion material will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation that the objectives and plans discussed herein will be achieved. Further, no person undertakes any obligation to revise such forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.
Important Information continued

**United States:** This material is for Institutional Investor use only - not for retail distribution. Muzinich & Co., Inc. is a registered investment adviser with the Securities and Exchange Commission (SEC). Muzinich & Co., Inc.’s being a Registered Investment Adviser with the SEC in no way shall imply a certain level of skill or training or any authorization or approval by the SEC.

Issued in the European Union by Muzinich & Co. (Ireland) Limited, which is authorized and regulated by the Central Bank of Ireland. Registered in Ireland, Company Registration No. 307511. Registered address: 32 Molesworth Street, Dublin 2, D02 Y512, Ireland. Issued in Switzerland by Muzinich & Co. (Switzerland) AG. Registered in Switzerland No. CHE-389.422.108. Registered address: Tödistrasse 5, 8002 Zurich, Switzerland. Issued in Singapore and Hong Kong by Muzinich & Co. (Singapore) Pte. Limited, which is licensed and regulated by the Monetary Authority of Singapore. Registered in Singapore No. 201624477K. Registered address: 6 Battery Road, #26-05, Singapore, 049909. Issued in all other jurisdictions (excluding the U.S.) by Muzinich & Co. Limited, which is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 3852444. Registered address: 8 Hanover Street, London W1S 1YQ, United Kingdom. 2023-04-24-10778