Staying in Short-Dated Credit to Potentially Take Advantage of Rate Curve Steepening

How will the normalization of the yield curve impact credit investors?

The past two years saw a rapid rise in interest rates as central banks tackled intensifying inflationary pressures globally. These policy measures put upward pressure across the rates curve. While the front end was anchored by central bank policy, the medium-to-longer part traded with a lower yield to reflect recessionary concerns and the anticipation of rate cuts. The result - an inverted yield curve - a rare phenomenon historically a precursor to recession.

However, towards the end of 2023, with central banks at peak policy rates and rate cuts expected in 2024 as inflation normalized, the rates curve rallied strongly. The whole curve moved significantly lower, except for the very short end (inside 2 years). We are now expecting this flattening momentum to turn into a steepening, driven by a move lower in the shorter part of the curve.

A Return to a ‘Normal’ Environment

During a ‘regular’ rates curve cycle, following an inversion, the curve typically flattens as policy rates fall and the front end of the curve moves lower. As this easing of monetary policy stimulates economic activity, the rate curve can steepen back to an upwardly sloping ‘normal’ shape. In short, we expect the 3-month to 2-year part of the rates curve to benefit more from central bank cuts than the belly and long end of the curve, which have largely anticipated the new environment of lower rates and a resilient economy.

Value in Short Dated Credit

With this in mind, we believe investors should not disregard the embedded value in short-dated credit. This value lies in the fact that the short end in our opinion offers the best carry whilst being most exposed to expected central bank rate cuts.

Short-dated bonds continue to offer a yield premium over longer-dated credit as well as some shelter from interest rate and spread volatility. Absent a significant recession, or a U-turn in central bank policy, we believe they are likely to outperform longer-duration assets over the medium term.

Furthermore, companies are benefiting from more favourable funding costs and a decent macroeconomic backdrop. In our view, the excess return potential of credit offers valuable compounding opportunities over the long term.
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