The past 18 months have witnessed a rapid rise in interest rates as central banks tackle intensifying inflationary pressures globally. These policy measures have put upward pressure on the front end of the rates curve, while rising recessionary concerns and the anticipation of rate cuts have resulted in an inverted rate curve. This is a rare phenomenon and has historically been considered a precursor to recession.

However, with central banks near or at peak policy rates, macroeconomic data continues to surprise on the upside - particularly in the US. Recessionary fears appear to be receding, and a ‘higher for longer’ rate and inflation outlook suggests the current curve inversion is no longer justified.

Rate Curve Inversion

Within a ‘normal’ market environment, the rate curve is upward sloping. This reflects the need for additional compensation for extra inflation and duration risk. This traditional curve shape can change - as we are currently seeing - on the back of shifts in monetary policy or economic expectations.

The 2022 yield curve inverted due to central bank monetary policy rate hikes, with the short end moving up to reflect higher policy rates. Subsequently, the long end fell to reflect the market’s belief that policy rates would return to lower levels in response to recessionary pressures, and as inflation returned to central bank targets. These combined factors resulted in the highest level of curve inversion since the early 1980s in the US, and early 1990s in Europe.

However, macroeconomic data continues to be relatively solid, and the economic ‘soft-landing’ narrative curated by the Federal Reserve has resulted in the slow dis-inversion of the rate curve. Investors who dogmatically followed the rate curve inversion playbook may now be reconsidering this position as that recession risk - and the related return to a low-rate environment - is being questioned.

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. However, we believe that the steepening in this cycle could instead come from the long end rising to reflect higher longer-term inflation, a higher-for-longer rate environment and an economic soft landing in the US.

Impact on Credit Portfolios

With this in mind, we believe investors should not disregard the embedded value in short-dated credit. This could again provide investors with protection should we see interest rates driving negative returns in longer-dated credit.

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.

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