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Surfing the Curve With Short-Duration Credit

Following a rapid tightening of policy rates, investors face high uncertainty about the direction of the economy and the strength of consumer and corporate balance sheets. Doubts persist as to whether equity market multiples or credit spreads compensate adequately for these uncertainties.

Against this background, we regard short-maturity investment-grade corporate bonds as highly attractive. This asset class currently offers a 4 – 6% yield, and because starting yield is closely correlated with total return in short-duration credit, it also offers the potential for incremental estimated return over cash while preserving much of the predictability and flexibility of cash.

In this article, we explore the appeal of the asset class, and argue for adding further spread with some flexibility to take global exposures and "extension" risk.

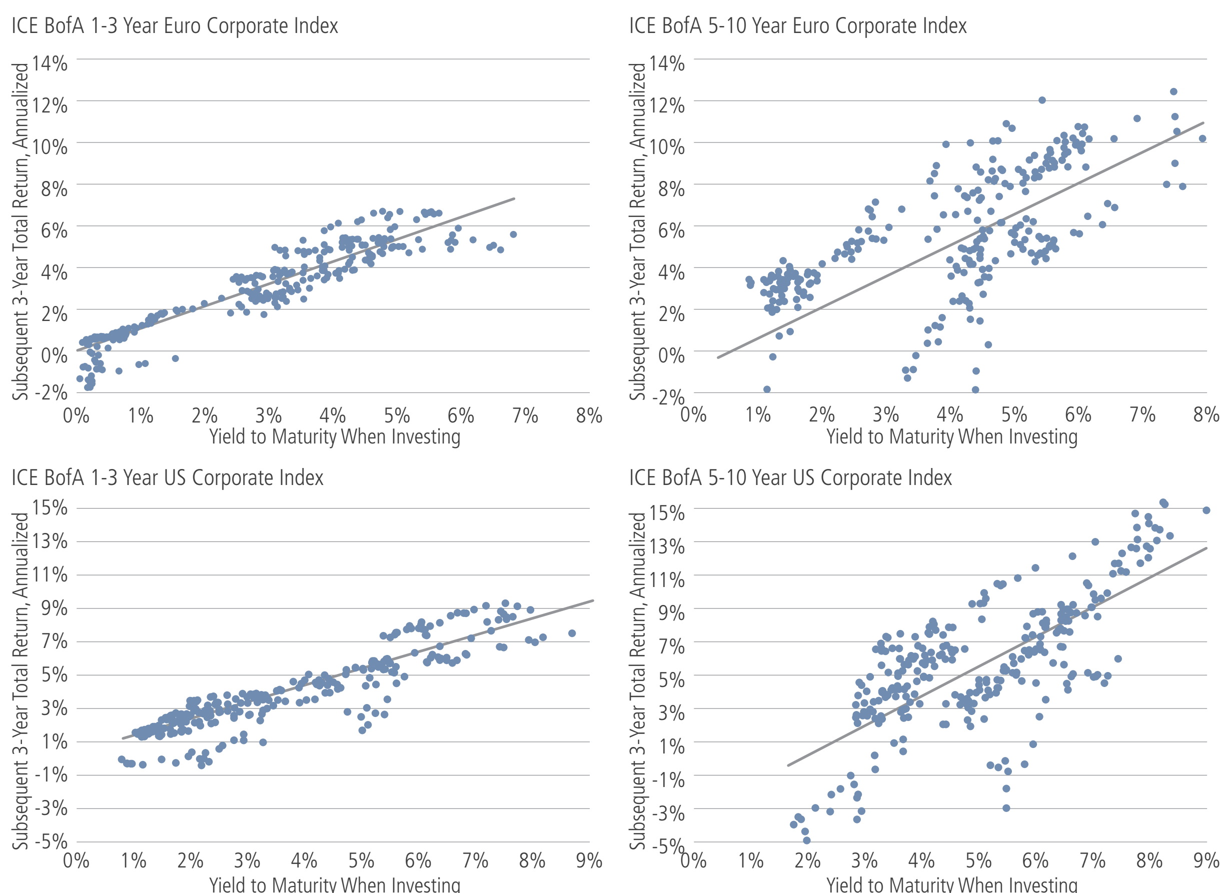
Predictability Amid Uncertainty

The closer to maturity a bond is when you buy it, the more likely its total return over the next two or three years will be determined by the yield when you bought it (figure 1).[1]

That stands to reason. It's a simple matter of the (fixed) income becoming a more important determinant of return than the (fluctuating) capital valuation. A short maturity reduces the sensitivity of the bond's price to changing rates. By improving the visibility of the issuer's capacity to pay the remaining coupons, it also reduces price sensitivity to economic conditions. Finally, a short maturity reduces the impact of reinvesting the coupons at a different yield than the starting yield. Hold the bond to maturity, and the effect of these three variables can disappear almost entirely.

[1] See Nathan Struemph, Mercer, "A lasting first impression: the role of starting yield in short duration credit performance" (January 2023).

FIGURE 1. STARTING YIELD IS A STRONGER DETERMINANT OF SUBSEQUENT RETURN IN SHORT-DURATION FIXED INCOME



Source: Refinitiv Workspace, Neuberger Berman. Data as of December 15, 2023.

We think this characteristic is particularly attractive in the current environment for three reasons:

- First and most obviously, current yields of 4 – 6% in investment grade credit are attractive in themselves.
- Second, in a time of high uncertainty around economic and credit conditions, any kind of predictability becomes valuable.
- Third, the dominance of starting yield in subsequent total return means that short-duration credit offers an incremental estimated return over cash while preserving much of the predictability and flexibility of cash.

When almost all of an asset's total return is income and its price volatility is very low, just as with cash, the income can either be reinvested or reallocated (perhaps into a sell-off in riskier assets); and the asset can be liquidated with low risk of capital loss (again, perhaps to fund a reallocation into cheapening riskier assets).[2]

Some investors may wish to take some exposure to potential credit-spread tightening. We are a little more cautious. Spreads are moderate rather than high, and arguably do not compensate for next year's weaker economic outlook.

Others might want exposure to interest rate risk if they believe, as we do, that the economy is likely to weaken next year, or if there is potential for policy rates to come down. Our view is that inflation may prove to be stickier than many anticipate, delaying the path of rate cuts—but, in any case, the flatness of yield curves means that lengthening maturity does not result in extra yield. In the event of further weakening in the economy and inflation, we would expect shorter-dated yields to fall further than longer-dated yields; and in the event of unexpected strength in the economy, we would expect longer-dated yields to rise further than shorter-dated yields.

[2] Max Becker and Chris Canstein of Mercer describe short-duration bonds as among a group of "liquid downside protection assets… that become dry powder in times of market drawdowns": "Lessons from past recessions: the best offense is a good defense" (March 2023) at https://insightcommunity.mercer.com/public/research/641cf2bb9e84d0001f68090b/Mercer_Lessons_from_past_recessions_The_best_offense_is_a_good_defense.

FIGURE 2A. CREDIT SPREADS ARE MODERATE, NOT HIGH…

ICE BofA Global Corporate Index, ICE BofA U.S. Corporate Index, ICE BofA Euro Corporate Index, option-adjusted spread

Source: Refinitiv Workspace, Neuberger Berman. Data as of December 15, 2023.

FIGURE 2B. … AND THERE IS NO ADDITIONAL YIELD FURTHER OUT ON THE CURVE

ICE BofA Global Corporate Index, yield to maturity

Source: Refinitiv Workspace, Neuberger Berman. Data as of December 15, 2023.

All that said, we do believe there is potential to squeeze more spread and yield out of the short-duration credit market than we currently see at the index level, beyond idiosyncratic credit selection. Rather than stretching out on the curve, we think the opportune way to seek risk now is to broaden the investment universe to include non-financial corporate hybrid securities, global markets and securitized products.

The Benefits of Flexibility: "Extension Risk"

It might seem strange to include corporate hybrids in our short-duration universe given how long-dated they tend to be—sometimes even perpetual. However, these securities are callable and their price tends to trade in line with the first call date, which can be short-dated just like any bond maturity. They trade this way because it is extremely rare for them not to be called.

Corporate hybrids are subordinate to senior bonds because they have equity-like features: not only can they be extended beyond their call dates, potentially in perpetuity, but their coupon payments can be deferred without a default. Credit rating agencies therefore treat them as half equity and half senior debt, making them an attractive option for issuers looking to optimize their cost of capital.

However, that "hybrid" status is typically forfeited if the security is extended. For example, S&P typically treats a non-called hybrid as straight senior debt when assessing the issuer's capital structure. Moreover, coupons are typically reset to a level equal to the hybrid's initial credit spread at issuance, plus the five-year interest rate swap rate at the time of the reset—plus, in some cases, an additional, punitive 25-basis-point "step-up". In the face of all that, there is very little incentive to leave this very expensive piece of senior debt outstanding.

That is why we believe "extension risk" tends to be modest. How well is it currently being compensated? After trading relatively tightly to senior investment grade credit through 2020 and 2021, it became increasingly attractive through 2022 and remains at relatively wide levels today (figure 3).

FIGURE 3. "EXTENSION RISK" HAS BECOME ATTRACTIVELY VALUED

ICE BofA Hybrid Non-Financial Corporate Index over ICE BofA Global Corporate Index, spread to worst

Source: Refinitiv Workspace, Neuberger Berman. Data as of December 15, 2023.

Investors in hybrid securities could also consider subordinate, callable bank bonds—Tier 2 Capital under the Basel III regulatory framework, which comes with its own idiosyncrasies and dynamics. These currently also trade with attractive extension premiums, following the failures of several regional US banks through 2023 and, especially, Credit Suisse in March.

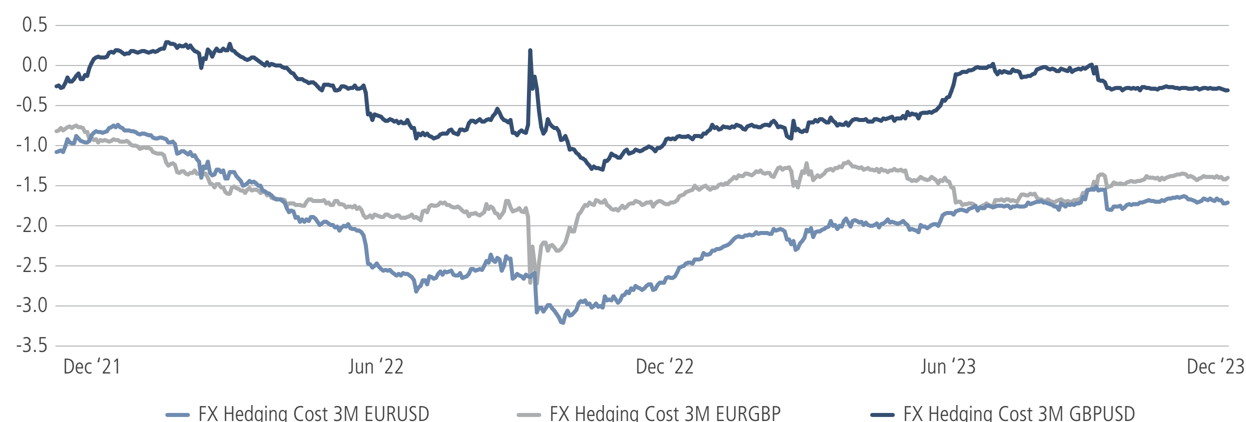
The Benefits of Flexibility: Global Exposure

Because the US Federal Reserve (Fed) has led the way in raising policy rates, yields in US credit markets have been relatively high. For the same reason, unfortunately, the costs of hedging US dollar exposure have also been high—especially for euro-based investors.

Over the past year, however, those costs have moderated significantly (figure 4). The annualized cost of hedging dollars back to euros has halved from 3.2% to 1.7%. The cost of hedging back to sterling has declined from 1.3% to 0.3%.

FIGURE 4. HEDGING COSTS FOR EURO- AND GBP-BASED INVESTORS HAVE EASED THIS YEAR

ICE BofA Hybrid Non-Financial Corporate Index over ICE BofA Global Corporate Index, spread to worst



Source: Bloomberg. Data as of December 15, 2023.

What does that mean for an investor's opportunity set?

As figure 5 shows, a euro investor can currently pick up some extra market yield by considering sterling-denominated bonds, even with the 1.4% hedging cost factored in. There is less opportunity to pick up extra hedged yield from the US dollar-denominated market, but the comparison is much more favorable than it was a year ago; and by adding this universe we also add choice and liquidity even if we cannot add yield.

Sterling-based investors are still generally better off staying at home, once hedging costs are factored in, at least in terms of yield. Again, going global can add choice and liquidity.

FIGURE 5A. HEDGED YIELDS LOOK ATTRACTIVE TO EUR-BASED INVESTORS…

Yield to maturity, hedged to EUR

Source: Refinitiv Workspace, Bloomberg, Neuberger Berman. Data as of December 15, 2023.

FIGURE 5B. … LESS SO FOR GBP-BASED INVESTORS

Yield to maturity, hedged to GBP

Source: Refinitiv Workspace, Bloomberg, Neuberger Berman. Data as of December 15, 2023.

It is also worth noting that this broader universe can include bonds from the same issuer, with the same maturity, but in different currencies, that nonetheless trade at different hedged yields. Sometimes this is a genuinely unexplained arbitrage opportunity; in other cases, the relative value can be explained by investors' preference for bonds in their domestic market, a liquidity premium, or differences in historical central bank purchase programs or local supply calendars.

Finally, while part of the attraction of short-duration credit is the limited exposure it has to interest rate risk, it is not entirely without interest rate risk, and it can make a difference once you move onto non-domestic yield curves. The Fed has historically tended to cut

rates ahead of either the European Central Bank (ECB) or the Bank of England in economic slowdowns; higher starting points may also give the Fed and the Bank of England more room to cut rates than the ECB. For a euro-based investor, therefore, some marginal exposure to US dollar or sterling duration could be attractive, in addition to the initial yield pick-up.

The Benefits of Flexibility: Securitized Products

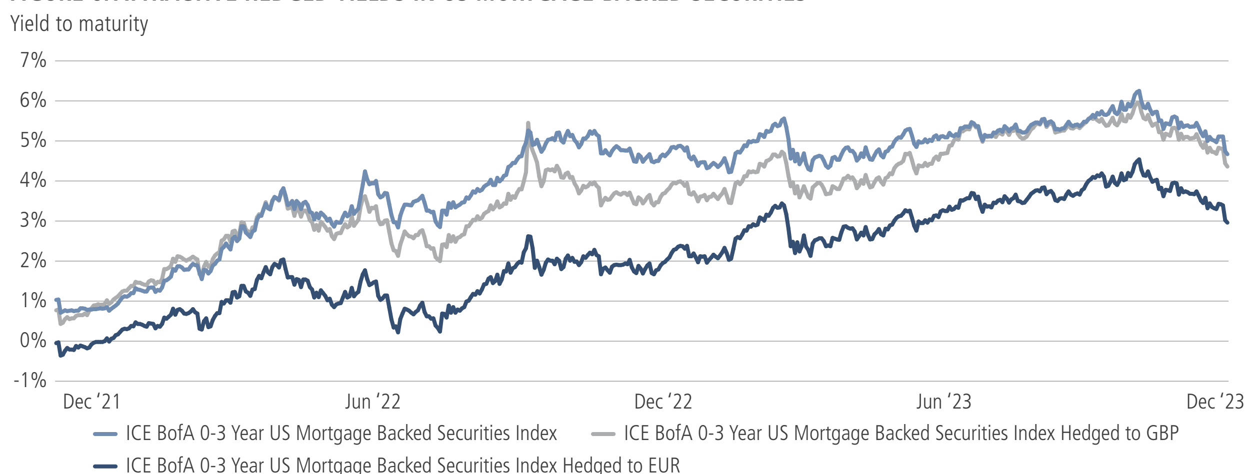
Investors willing to explore US investment-grade markets may wish to expand their universe further, beyond corporate bonds and into securitized products.

For investors concerned about the impact on corporate bonds of the economic slowdown securitized products offer diversification into more consumer-oriented debt (from credit cards and auto loans to timeshares and cellphone contracts) and more unusual corporate sectors (such as telecommunications infrastructure, aircraft and equipment leasing).

We think US agency mortgage-backed securities (MBS) are particularly attractive at the moment. Figure 6 shows the yield available to euro- and sterling-based investors from short-duration US Agency MBS: at 4 – 5%, it is only 50 – 100 basis points lower than for US corporate bonds, with a substantially higher-quality average credit rating.

FIGURE 6. ATTRACTIVE HEDGED YIELDS IN US MORTGAGE-BACKED SECURITIES

Yield to maturity



Source: Refinitiv Workspace, Bloomberg, Neuberger Berman. Data as of December 15, 2023.

The sector is supported by relatively resilient consumer and housing-market dynamics. Moreover, the key risk of early or faster-than-scheduled prepayment is muted, as most borrowers are happy to stick with the lower rates they locked in some years ago rather than refinance at today's higher rates. Taking short-duration exposure mitigates that risk still further.

The technical backdrop is also supportive: the market struggled to digest heavy issuance of securitized products in general through 2022, and that pushed yields up. Agency MBS brings an added twist, as the buyer base has shifted dramatically away from banks (which tend to be overwhelmingly buy-and-hold investors) to asset managers (which tend to trade more often)—an established trend amplified by the mini-banking crisis in spring 2023. The broader market has begun to transition itself away from a buy-and-hold market to a greater free float, and new issuance has been much lower in 2023, potentially building a technical tailwind for the asset class.

A Little Predictability at a Time of Uncertainty

Investors face considerable uncertainty in the months ahead. The path of inflation remains uncertain; how central banks will react to that path remains still more uncertain; the underlying strength of growth in the major economies depends to a large extent on the lagged impact of rate hikes and the potential policy responses to come; and doubts persist about whether credit spreads compensate for the pressure that higher rates may exert on corporate balance sheets.

Against this backdrop, we believe short-duration investment grade credit comes with a lot of advantages. Yields are at attractive levels, and those yields are likely to correlate strongly with total returns over the coming year; there is little or no extra yield available further out on the curve; and in our view the likelihood of curves steepening in the coming year, rather than flattening or inverting again, is high. With additional spread available to flexible strategies that explore extension risk, global markets and securitized products, we think short-duration investment grade credit is attractive for fixed income investors as they head into 2024.

Indices Used

The **ICE BofA Global Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, issued and denominated in their own domestic market and currency.

The **ICE BofA US Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, issued and denominated in U.S. dollars.

The **ICE BofA Euro Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, issued and denominated in euros.

The **ICE BofA 1-3 Year Euro Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, with maturities of between one and three years, issued and denominated in euros.

The **ICE BofA 5-10 Year Euro Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, with maturities of between five and 10 years, issued and denominated in euros.

The **ICE BofA 1-3 Sterling Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, with maturities of between one and three years, issued and denominated in GBP.

The **ICE BofA Hybrid Non-Financial Corporate Index** tracks the performance of investment grade non-financial hybrid corporate debt publicly issued in major domestic and Eurobond markets.

The **ICE BofA 0-3 Year US Mortgage Backed Securities Index** tracks the performance of US dollar-denominated, fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. Agencies in the domestic market, with maturities up to three years.

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