Allianz Global Investors

MAY 2024

The case for short duration credit strategies

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The narrative in global markets has shifted from a hard landing to a soft or even no landing scenario. This is positive for corporate credit and equities. But it has made expressing a view on interest rates harder. The traditional upward sloping yield curve, where investors require a risk premium to hold more volatile longer dated assets, has been inverted for some time. Sticky US inflation suggests that this inversion could remain for now.

This raises the question, should you hold a low volatility short-dated higher yielding asset, or a longer-dated higher volatility lower yielding asset that needs prices to rise just to match the return of the shorter asset?

Government yields are higher for short durations, than longer ones

Exhibit 1 illustrates market consensus for US, European and UK government bond markets. The black line in the charts is the current yield curve and the blue and yellow lines show what the market expects the yield curve to look like in 6- and 12-months' time. The bars illustrate the quantum of expected movements.

Exhibit 1: Sovereign yield curves

US Treasury Actives Curve

EUR German Sovereign Curve

GBP Sovereign Curve

Spot vs 6 month forward (right axis) — Spot — 1 Yr — 6 Mo
Spot vs 1 yr forward (right axis)

Source: Bloomberg 1st May 2024

We believe there are a couple of easy conclusions to draw from these charts:

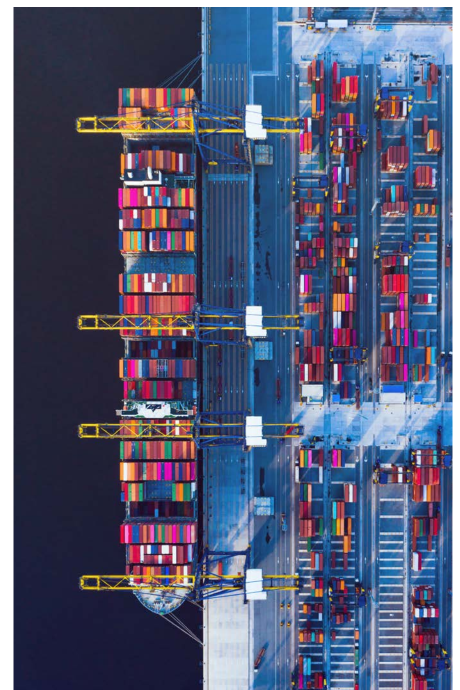
1. You get a higher yield at up to 2 years than any other period.
2. The market expects the impact of rate cuts to be at short durations rather than at longer durations.

These conclusions beg the question, why would you invest in long duration US government bonds?

The charts show the yield is less, and markets do not expect a significant move in this yield in the coming 12 months.

Get paid to wait

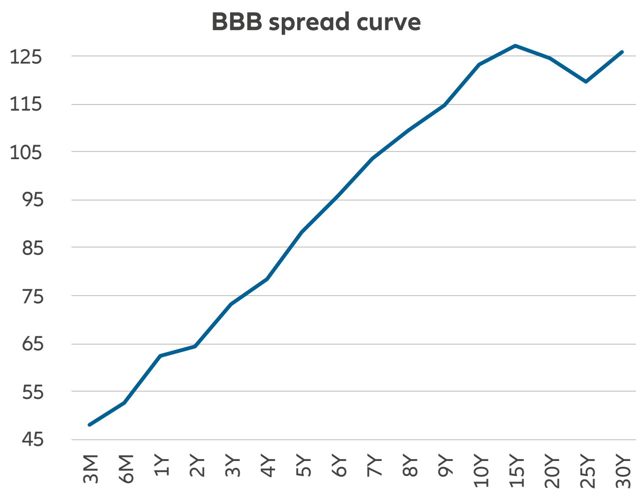
We believe the higher yield on offer in short duration bonds makes for a compelling argument for investing. And if the expected rate cuts happen, there should be an additional return boost from the, albeit short, interest rate duration effect.

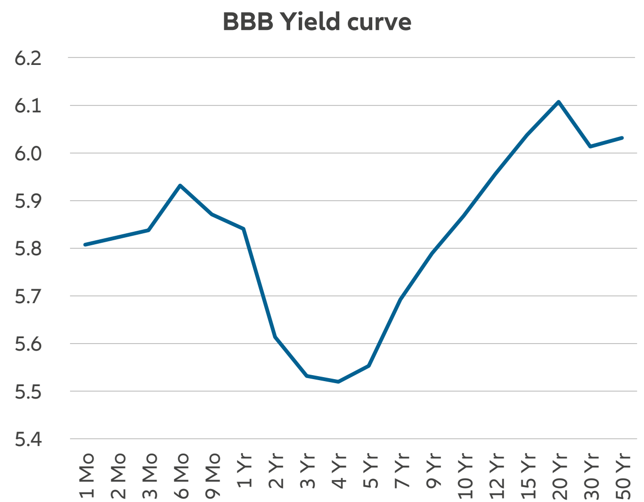


In credit, you need to move to high yield for upward sloping yield cures

For some investors, the outright yield even at the front end may not be high enough. They may seek to enhance yields by adding credit risk. As an illustration Exhibit 2 below shows US BBB credit curves in two different ways. On the left, is the credit spread, and this looks normal: the longer the maturity, the higher the spread. However, the chart on the right shows the absolute yield, and the inverted government yield curve is the main driver. The right-hand chart shows that 1-year risk yields the same as 9-year risk. We believe you need to be paid both more yield and more spread for a lengthier exposure. Credit markets can operate independently from the government bond market and correct this anomaly by demanding higher credit spreads for longer maturities, thus offsetting the yield curve. As shown in Exhibit 3, for B credit, where default rates are higher, this is already the case. However, if BBB curves shifted similarly, there would be capital losses during the adjustment phase.

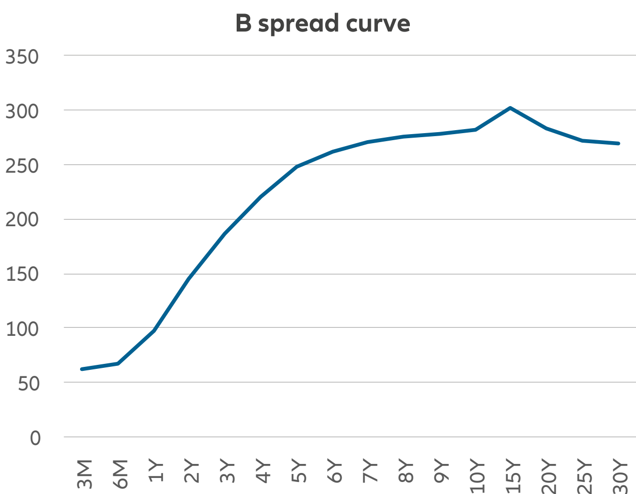
Exhibit 2: BBB spread and yield curves

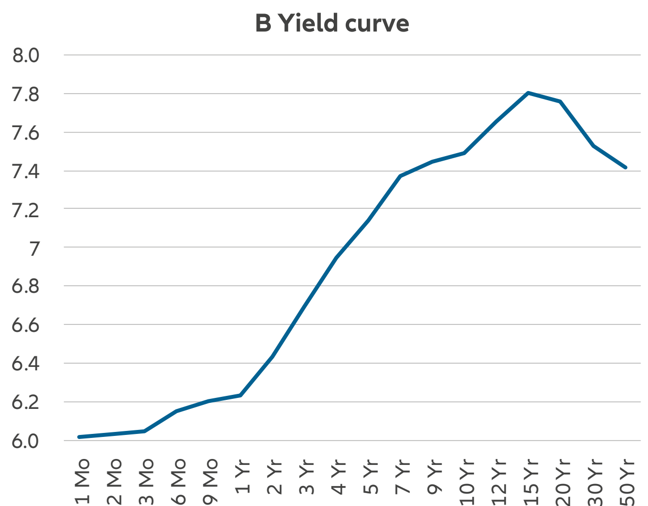




Source: Bloomberg 1st May 2024

Exhibit 3: B spread and yield curves





Source: Bloomberg 1st May 2024

Yields are close to 20-year highs, but are not expected to drop significantly

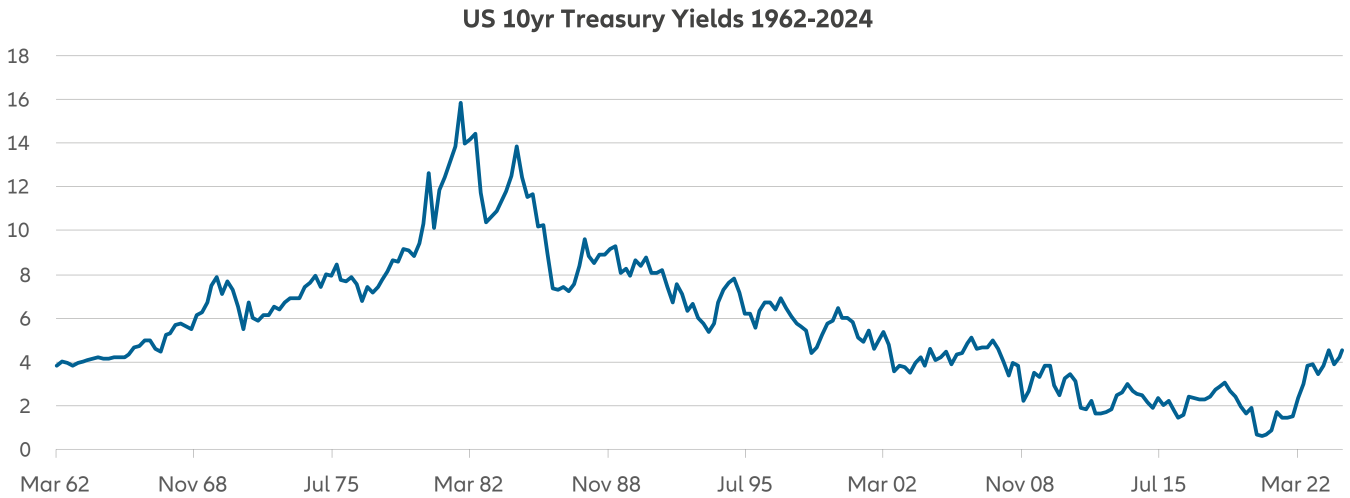
The opposing viewpoint suggests that, given bond yields are nearing their highest levels in two decades, as demonstrated in Exhibit 4, it could be prudent to secure these yields at present.

If short term rates drop as shown in Exhibit 1, when a bond matures, an investor will have to reinvest at lower rates. Locking in yields could make sense if one believes that the yields from before the global financial crisis (GFC) won't happen again; but if one sees a risk of yields rising further one could realise losses. Plus, the expected yield of one-year bonds in a year's time is about the same as the current 10-year bond, so one may not need to rush into a decision.

With credit spreads through averages, it isn't the time to extend spread duration

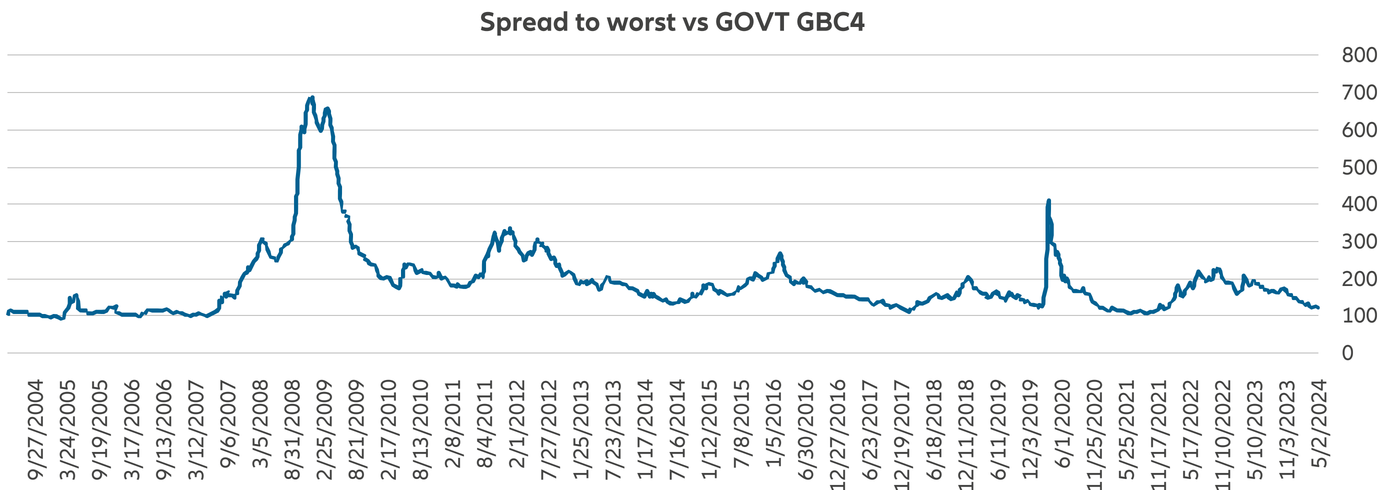
For those who want the extra yield by allocating to credit, one can see that spreads are somewhat through their average. Using simple mean reversion, spreads are more likely to widen than tighten as seen in Exhibit 5 when spread are tighter than 125bp.

Exhibit 4: US 10yr treasury yields 1961-2024



Source: Bloomberg 1st May 2024

Exhibit 5: BBB spreads (2003-2024)



Source: Bloomberg 1st May 2024

Most investors are return focused; while yield does not always equal return, at the outset of an asset allocation decision it is a good starting point. Our belief is that front-end yields may remain to be attractive for the next 12 months.

These scenarios are dynamic. An investing strategy should be as well

Thereafter, it is difficult to gauge, so flexibility may be important. Credit spreads do look somewhat vulnerable relative to long term averages and while there is a normal upward sloping spread curve, in BBB it isn't enough to offset the inverted government yield curve. From a government bond perspective, if owning a 9-year credit bond holds no advantage over a 2-year bond, and if one believes that credit spreads are tight, then there is no strong justification for holding longer dated credit.

The suitability of global multi asset credit today

Global multi asset credit strategies typically have cash related benchmarks and are free to invest across liquid credit asset classes, with no fixed duration target, although most are short-duration. They may invest from AAA to CCC, across developed and emerging markets and all industries. Importantly, these types of strategies have the ability to alter its duration and credit profile to suit the ever changing fundamental and technical environment.

Currently, we believe that generic global multi asset credit is ideally positioned for the shape of yield curves and the broad outlook for rates and credit. However, if this outlook changes, the lack of constraint from a defined credit benchmark allows these funds to adapt quickly to any new information. The risk for non-benchmarked strategies is that it is more difficult to assess how they will perform as there is no benchmark to derive historic data from. In addition, the unconstrained nature of these types of strategies can mean that future performance could be very different from historic performance.

The suitability of trade finance today

Unlike multi asset, trade finance does not have the flexibility to extend duration significantly although it can shift its credit profile.

Trade finance benefits from very short spread duration and studies[1] have shown that trade finance typically has lower default rates and higher recovery rates than other more traditional credit asset classes. This makes trade finance a defensive asset class in periods of uncertainty, while still having attractive yields. While the relative yield of trade finance versus some other asset classes may have compressed, this is due to its defensive nature. If the credit environment worsens trade finance could still outperform as public market spreads can widen more. Yield does not equal return, and in uncertain markets, we like the relative certainty of short-dated trade finance.

[1] Source: Berne Union 2023 Yearbook; Moody's Global: Annual default study 2022, exhibit 31 – average one-year letter rating migration rates 1920- 2022.

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