Fixed income insights

March 2022

Short duration bonds: resilience in the face of uncertainty

HSBC Asset Management

Short duration resilience

In the first quarter of 2022, fixed income investors have faced singular market uncertainty, with:

- inflation at levels not seen for two generations, and the strength and persistence of inflationary trends greater than central banks had expected;
- the ongoing effect of Covid-19 on supply chain bottlenecks, including labour supply; and,
- persistently strong demand as economies unlock, underpinned by the residual effects of fiscal and monetary stimulus policies.

This already formidable uncertainty has, of course, been exacerbated by the developments in Eastern Europe and potential risks ahead.

A base prediction for interest rate hikes

The Bank of England and Bank of Canada have already begun raising rates, and it seems inevitable that other major developed market central banks will need to follow suit. Winding down quantitative easing (QE), interest rate increases and quantitative tightening (QT) are at the center of the policy agenda. This, along with renewed geopolitical tensions, could be a calling card for considering an allocation, or even increased allocation to short duration fixed income.

The US Federal Reserve's (the Fed's) policy outlook changed significantly in the last months of 2021, and it continues to evolve at pace so far in 2022. In its March meeting, the Fed made material revisions to its economic forecasts and it is very clear that the trend for policy rates is upwards.

- Rates markets are now pricing in a strong chance of six further hikes this year for the US (see Figure 1), something the Fed's dot plot now also matches, with three further hikes forecasted in 2023.
- With measures of inflation continuing to rise and with widespread evidence of a tight labour market, we think the Fed's thresholds on inflation and employment have been more than met. The Federal Reserve enacted its second consecutive 75bps rate hike in July 2022.
- We also anticipate the Fed to announce its plans for balance sheet reduction in the middle of the year and to begin allowing QE bond holding run-off (i.e. for QT to commence) soon after.

Three main concerns are driving bond market uncertainty:

1. **Inflation**. Rising prices remain far above target and inflation figures are at highs that haven't been seen for decades; energy, commodities, housing are all contributing to these highs
2. **Continued supply chain disruption.** The situation in Ukraine is likely to result in heightened commodity prices and to further unsettle supply chain logistics
3. **Interest rate hike.** The Federal Reserve enacted its second consecutive 75bps rate hike in July 2022.

Author

Michael Cross
Global Head of Fixed Income

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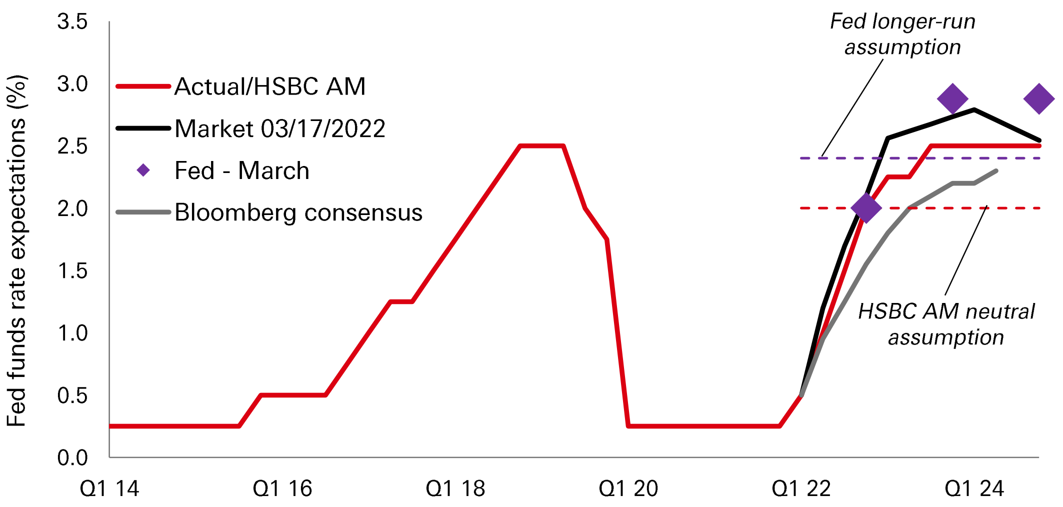
Figure 1. US rate hikes and expectations (2014-2024)



Source: Bloomberg, HSBC Asset Management

Can rates rise faster than anticipated?

There are downside risks to the pace of the Fed's hiking cycle, particularly if an intensification of geopolitical tensions depresses the global recovery from the Covid-19 pandemic. But most investor attention has been on upside risks to inflation and to the hiking cycles. The Fed may have to hike rates at a faster pace:

1. if the trajectory of inflation does not moderate as quickly as forecast; and
2. if supply bottlenecks have not abated; and
3. if demand takes longer than expected to rebalance from goods to services

In addition, if labour supply constraints remain elevated through H2 2022 and into 2023 and stronger-than-desired wage growth persists, the Fed would have to take further measures to prevent economic overheating.

Are investors getting paid to take duration risk?

In a rising rate environment, most investors are reluctant to take on duration risk unless they have specific liability matching requirements. Longer duration investments would only be appropriate if rates at the long end were expected to fall or if the term premium was unusually attractive (and investors were paid for taking the risk).

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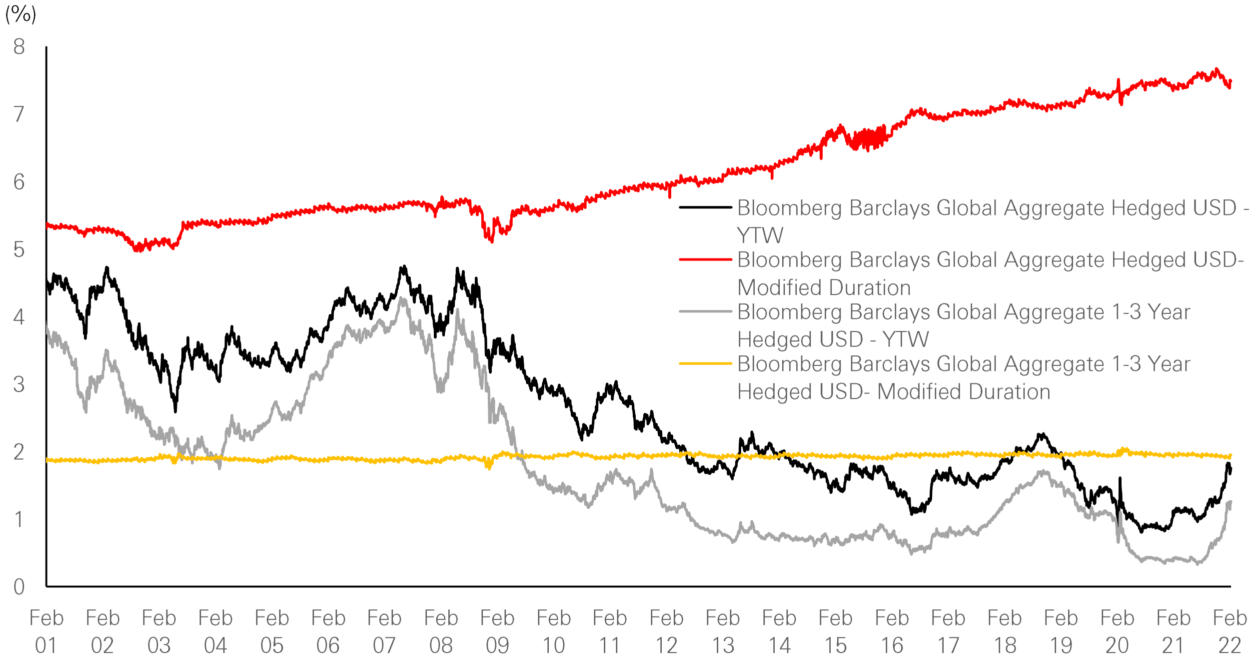
However, a review of the Barclays Global Aggregate Index (longer-duration index) and the Barclays Global Aggregate Index 1-3 year (shorter duration index) over the past twenty years shows that the trend for the longer duration index is a significant drift in duration risk compared to its yield: the index duration has increased by 41% to 7.4 years over the period, while its yield has fallen by 59% to 1.8% therefore causing a massive drop in compensation per unit of interest rate risk. (See Figure 2.) This compares unfavorably to the Barclays Global Aggregate 1-3 Year Index where duration has increased by a much smaller 3% to 1.9 years and the yield has fallen by 60% to 1.2%. So, it is reasonable for investors to consider whether they have been fully compensated for the duration of the Global Aggregate versus its short duration alternative.

Figure 2. Increased duration risks for longer duration benchmarks



Source: Bloomberg, HSBC Asset Management. Data as of 28 February 2022

Short duration resilience

Further, a review of the past two rate hiking cycles (in 2015-2018 and in 2004-2007) indicates that the short duration Bloomberg Barclays Global Aggregate 1-3 Year Index outperformed its longer duration sibling significantly on a risk-adjusted return basis. (See Figure 3.)

Figure 3. Risk-adjusted performance[1] comparison during rate hike environments

	Bloomberg Barclays Global Aggregate	Bloomberg Barclays Global Aggregate 1-3 Years
Pre-COVID rate hike (1 Sep 2015 to 19 Dec 2018)	0.9	3.9
Pre-GFC rate hike (29 June 2004 to 17 Sept 2007)	1.1	3.3

Source: Bloomberg, HSBC Asset Management. Data as of 28 February 2022.

[1] Calculations show annualized returns divided by annualized standard deviation

It is worth acknowledging that in rising rate environments, investment grade fixed income gains are not generally captured through capital appreciation in the form of spread compression. Rather, returns are made (or protected) through income or clipping the coupon.

Short duration resilience

In addition, high quality corporates offer an attractive yield pick-up versus government bonds while providing regular income streams. Short duration investment grade corporates tend to offer consistent risk-adjusted returns over time while serving in a defensive stance against unforeseen volatility. Finally, the credit risk element is reduced in short duration fixed income due to the short period left to maturity—known as the "pull to par" effect. Short duration bonds can recover or 'heal' relatively quickly in a market sell-off or downturn relative to longer-maturity fixed income segments. In fact, demand for short duration bonds tends to increase in times of amplified uncertainty: they provide lower, less pronounced drawdowns and speedier recoveries.

Figure 4 illustrates this point, comparing the longer-term and short duration (1-3 years) segments of the US investment grade credit market. We show the six largest drawdowns in US corporates since 2007 and their respective recovery speeds (in days). Interestingly, the recovery period for the largest drawdown in longer-term US corporate bonds was 155 days compared to only 63 days for the 1-3-year index (See Figure 5.)

Figure 4. Shorter duration corporates protect on the downside

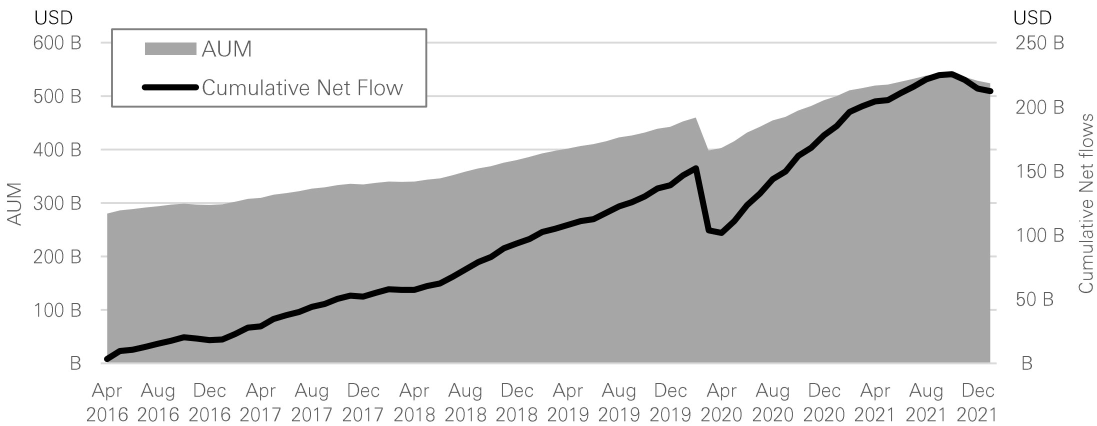
US Corporates			US Corporates 1-3 years		
Date	**Drawdown**	**Speed of Recovery**	**Date**	**Drawdown**	**Speed of Recovery**
31/10/2008	-16.0%	155	23/02/2022	-2.1%	ongoing
20/03/2020	-15.4%	74	13/06/2008	-1.8%	58
23/02/2022	--7.8%	ongoing	19/03/2020	-1.2%	16
05/09/2013	-6.4%	149	25/05/2011	-1.0%	31
26/06/2015	-4.5%	190	24/06/2013	-0.9%	63
16/12/2016	-4.5%	112	21/12/2015	-0.7%	59

Source: Bloomberg, HSBC Asset Management. Data as of 28 February 2022.

Repositioning to shorter duration opportunities

As the post-pandemic economy continues to provide strong economic growth and anticipation of central bank rate hikes become more anchored, rates have been on the rise since September 2020. Investors anticipated this and began moving into short duration strategies in May 2020 (See Figure 5.)

Figure 5. Short duration strategies have become more popular with investors

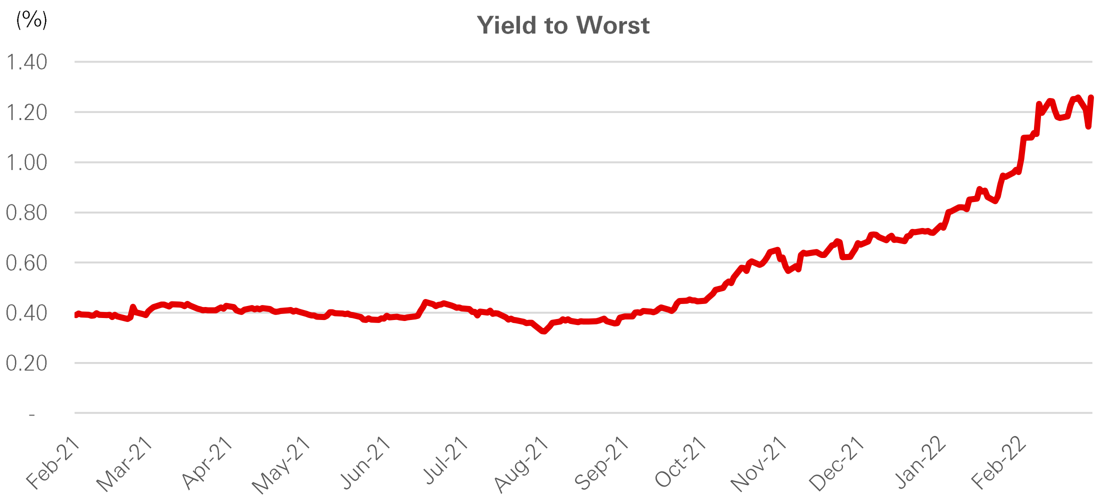


Source: Broadridge, HSBC Asset Management. Data as of 31 December 2021

Short duration resilience

However, if investors have already moved into short term fixed income, has the opportunity gone away? To answer the question, it's necessary to determine what the market has already priced in. Just by looking at the yield of the Bloomberg Barclays Global Aggregate 1-3 Year Index as an indicator (See Figure 6), we can see the recent spike in yield suggests the market is already pricing in considerable negativity due to the factors discussed above (anticipation of sticky inflation, higher rates and geopolitical risks). This has caused yields in the short duration credit space—as represented by the short duration 1-3 year index—to be historically very attractive. Only a few months ago, investors were wary of short duration strategies because the yields seemed too low. Today, this is no longer the case and yields have returned to pre-pandemic levels.

Figure 6. Historical yields for the Bloomberg Global Aggregate 1-3 Year Index



Source: Bloomberg, HSBC Asset Management 1 Feb 2021 – 2 March 2022

Short duration assets could provide resilience from four perspectives:

1. the potential higher carry the asset class could offer compared to longer duration ones
2. the "pull-to-par" effect described previously
3. shorter-term bonds mature quickly allowing for favourable reinvestment opportunity
4. potential spread narrowing could further mitigate the impact of higher rates

Short duration resilience

What are the stakes in short duration fixed income today?

All investment decisions have risks and it makes sense to address how a potential position in shorter-term bonds could behave should our current forecasts be off-base. For example, what would it take for rates to fall and how badly could an investor in short duration credit lose out?

We would argue that decreasing rates in the foreseeable future are unlikely, especially given macro-economic fundamentals; however, there are some scenarios that could cause a decline in rates:

1. global growth could slow dramatically--through an exogenous shock or if demand were to drop off significantly-more-than-forecasted during initial monetary tightening and fiscal pullbacks
2. geopolitical tensions could escalate further
3. inflation figures could fall significantly and rapidly; we believe that price pressures should ease gradually throughout 2022, but if inflation were to drop quickly and extensively, it could cause central banks to re-evaluate their hawkish stances.

As Figure 7 shows, the cost of getting the rates call wrong has not resulted in a lost opportunity for investors in the past. In fact, the short duration fixed income segment outperformed the longer-duration Bloomberg Barclay's Global Aggregate Index.

Figure 7. Risk-adjusted performance[1] comparison in decreasing rate environments

	Bloomberg Barclays Global Aggregate	Bloomberg Barclays Global Aggregate 1-3 Years
2019 and COVID rate cuts (31/07/2019 to 29/05/2020)	1.5	3.8
Post GFC (17/09/2007 to 16/12/2008)	1.2	3.1
Post tech bubble (02/01/2001 to 29/06/2004)	0.8	2.0

Source: Bloomberg, HSBC Asset Management. Data as of 28 February 2022

[1] Calculations show annualized returns divided by annualized standard deviation

Conclusion

The data shows that short duration bonds can provide a source of stable income, assist in protecting fixed income portfolios during rate increases and, especially important, can offer investors downside protection as they are a "naturally healing" segment of global fixed income. They also provide competitive yields relative to longer-dated maturities—even without a term premium.

Many investors tend to consider allocations to short duration bonds only in rising rate environments; however, we believe there is a strong case for investing in short duration assets more broadly—as a consistent and fundamental part of a balanced fixed income portfolio.

Key risks

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

Exchange rate risk Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly.

Foreign and emerging markets risks. Investments in foreign markets involve risks such as currency rate fluctuations, potential differences in accounting and taxation policies, as well as possible political, economic, and market risks. These risks are heightened for investments in emerging markets which are also subject to greater illiquidity and volatility than developed foreign markets.

High yield risk. Investments in high yield securities (commonly referred to as "junk bonds") are often considered speculative investments and have significantly higher credit risk than investment grade securities. The prices of high yield securities, which may be less liquid than higher rated securities, may be more volatile and more vulnerable to adverse market, economic or political conditions.

Asset-backed securities (ABS) are bonds that are created from various types of consumer debt. They are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments.

Liquidity risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors.

Counterparty risk. The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations.

Operational risk may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things.

Derivatives risk Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset.

Investment Leverage Risk. Investment Leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source

Interest rate risk When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Default risk. The issuers of certain bonds could become unwilling or unable to make payments on their bonds.

Credit risk. A bond or money market security could lose value if the issuer's financial health deteriorates.

Investment fund risk. Investing in other funds involves certain risks an investor would not face if investing in markets directly. Governance of underlying assets can be the responsibility of third-party managers.

CoCo bond risk. Contingent convertible securities (CoCo bonds) are comparatively untested, their income payments may be cancelled or suspended, and they are more vulnerable to losses than equities and can be highly volatile.

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HSBC Global Asset Management (Singapore) Limited
10 Marina Boulevard, Marina Bay Financial Centre, Tower 2, #48-01, Singapore 018983
Telephone: (65) 6658 2900 Facsimile: (65) 6225 4324
Website: www.assetmanagement.hsbc.com.sg
Company Registration No. 198602036R