

European Short Duration Fixed Income: A defensive asset class in an uncertain world

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- **Market moves in 2022 have shaped a strong argument for short duration fixed income solutions:** 2022 saw government bond yields move sharply higher, credit spreads widen above long-run averages, and yield curves flatten. This was driven largely by persistently high inflation and hawkish central banks, who delivered multiple base rates hikes in an attempt to tame inflation.
- **The prospect of less hawkish central bank policy should be supportive for short duration assets in 2023:** With signs that inflation could be trending lower, policy and short-term interest rate uncertainty is expected to decrease as Central Banks pivot to a more balanced policy mix focused on growth and inflation.
- **Historically, higher yields have provided investors a much better starting point to generate positive absolute returns:** We believe higher yields should provide investors with more 'carry' and a better cushion against further credit spread widening and/or interest rate volatility. In addition, both government and credit curves flattened in 2022. The net result is that short duration high quality bond yields are at levels that can help meet investor goals without the need to extend duration or increase credit risk.
- **Corporates entering 2023 from a strong position:** Issuers are going into the year with defensive business models, strong liquidity, optimised costs from the Covid era, and leverage that recognises the risk to profitability in 2023. We do not expect a spike in default rates.
- **Credit Valuation:** The widening of credit spreads in 2022 reflects the widening of swap spreads as well as weaker credit markets. We expect credit spreads to remain range bound above long run averages reflecting current macro uncertainties. Tighter swap spread and carry should be a driver of returns with government bond yields and credit spreads at attractive levels. Expect sector dispersion and outperformance from financials.

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2022: A sharp rise in yields

After more than a decade of low inflation and low growth that allowed for ‘easier’ monetary policy (low/negative interest rates coupled with quantitative easing programmes), central banks were forced to aggressively tighten monetary policy in 2022 in response to persistently high, supply-side driven inflation. The subsequent market moves in government bond yields and credit spreads have shaped a strong argument for short duration fixed income strategies.

The yield on a 2-year German government bond was 338 basis points higher, rising from -0.62% to 2.76%. The credit spread of the Bloomberg 1–3-year EUR investment grade corporate index rose 73bps from 65bps to 138bps. The yield of that very same index rose 4.1%, increasing from -0.01% to 4.09% (see *Display 1*).

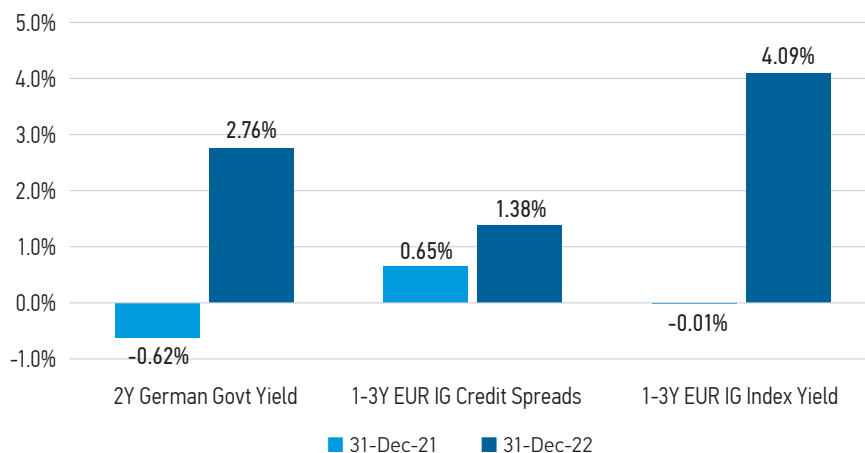
The prospect of a less hawkish central bank policy should be supportive for short duration assets in 2023:

Central bank rate hikes in 2022 were accompanied by the message that tackling inflation remained the primary goal, and the cost of lower growth / recession was a worthwhile price to pay. With signs that inflation could be trending lower, policy and short-term interest rate uncertainty is expected to decrease as central banks pivot to a more balanced policy mix focused on growth and inflation. This should support the absolute return prospects for short duration fixed income assets as it reduces the risk that rates rise at the same pace as they did in 2022.

Display 2 shows that the market is currently pricing for the ECB to continue raising rates until the middle of 2023, peaking at 3.5% and stabilising thereafter.

DISPLAY 1

2022: Sharp move higher in short duration yields

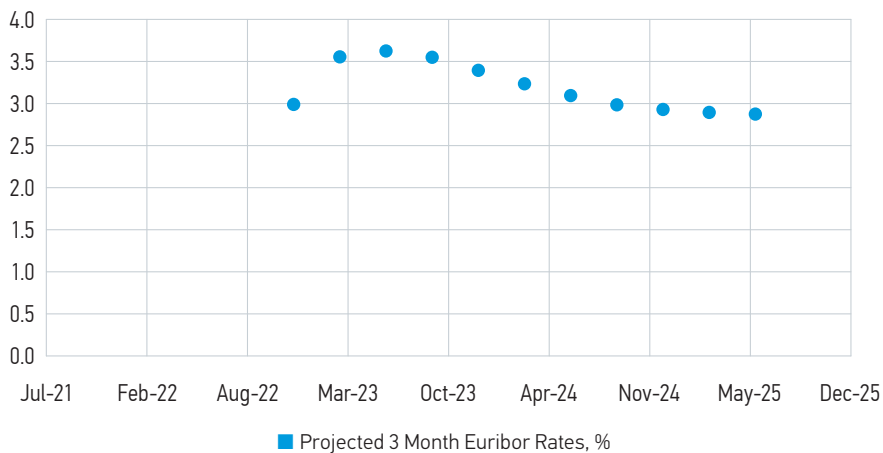


Source: Bloomberg, as at 31st December 2022. Index refers to Bloomberg Euro Corporate Bond 1-3 Year Index. The index is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.

DISPLAY 2

3-month expected Euribor rates derived from Euribor futures

As of 31st December 2022



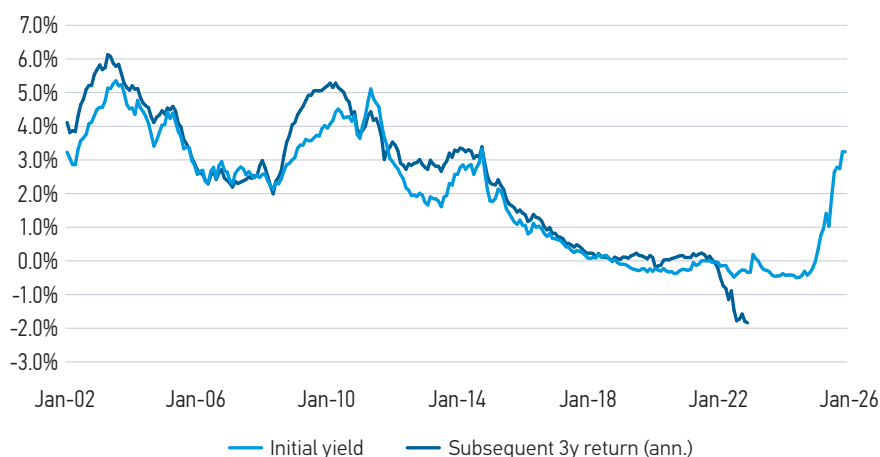
Source: Bloomberg, as at 31st December 2022. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Historically, higher yields have provided investors a much better starting point to generate positive absolute returns:

HIGHER YIELDS should provide investors with more ‘carry’ and a better cushion against further credit spread widening and/or interest rate volatility, in our view. *Display 3* shows the initial yield on the 1-3y EUR Investment Grade Corporate Index, and the subsequent 3-year return. It indicates that the initial yield on the portfolio gives a fairly good forecast of what average returns will be over the next 3 years, as the running yield on the portfolio is the major driver of returns and capital gains/losses being relatively small.

MORE CUSHION: *Display 4* shows that over a one-year period, 1-3-year investment grade credit spreads would need to widen more than 75 bps for an investor to not ‘break-even’ versus owning equivalent maturity government bonds. Separate analysis also shows that the combination of 1-3-year credit spreads and government bond yields would have to widen approximately 179 bps for an investor tracking the 1-3-year Bloomberg European Corporate Index to experience a negative one-year return.

DISPLAY 3
Initial yield on the 1-3y EUR IG Corp index, and the subsequent 3y return



Source: MSIM, Bloomberg, as at 31st December 2022. Index refers to Bloomberg Euro Corporate Bond 1-3 Year Index. The index is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results**

DISPLAY 4
1-3-Year European Investment Grade Excess Return Scenarios

BARCLAYS EUROPEAN CORPORATE BOND 1-3YR INDEX AS OF 31 DECEMBER 2022

OAS	138	Spread Duration	1.99	
RETURN SCENARIOS				
Δ Spread	Carry	Spread	Roll	Excess
-90	1.38%	1.79%	0.10%	3.27%
-75	1.38%	1.49%	0.10%	2.97%
-60	1.38%	1.19%	0.10%	2.67%
-45	1.38%	0.90%	0.10%	2.38%
-30	1.38%	0.60%	0.10%	2.08%
-15	1.38%	0.30%	0.10%	1.78%
0	1.38%	0.00%	0.10%	1.48%
+15	1.38%	-0.30%	0.10%	1.18%
+30	1.38%	-0.60%	0.10%	0.88%
+45	1.38%	-0.90%	0.10%	0.58%
+60	1.38%	-1.19%	0.10%	0.29%
+75	1.38%	-1.49%	0.10%	-0.01%
+90	1.38%	-1.79%	0.10%	-0.31%
SPREAD WIDENING NEEDED TO BREAKEVEN VS BUNDS				
Δ Spread	Carry	Spread	Roll	Excess
+75	1.38%	-1.48%	0.10%	0.00%

Source: Bloomberg, as at 31st December 2022. The index is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.**

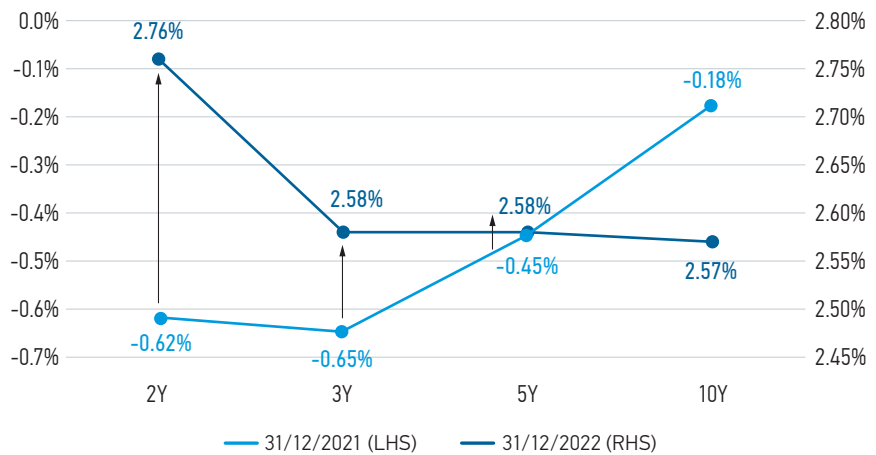
FLATTER YIELD CURVES: 2022 saw yield curves flatten. The yield on the 2-year German government bond was 338 basis points higher, while the yield on the 5-year German government bond rose 303 basis points and 10-year yield rose 275 bps. Credit curves also flattened: 1–3-year credit spreads widened 73 bps, while 7–10-year credit spreads widened relatively less, by 64 bps. The net result is that short duration fixed income yields are at levels that can help meet investor goals without the need to extend duration or move down in credit quality.

As of 31st December 2022, the yield of the Bloomberg 1–3-year European Corporate Bond Index was 4.09%. By comparison, the yield of the Bloomberg 7–10-year European Corporate Bond Index was 4.4%. So, investors can achieve nearly the same running yield in shorter duration bonds than they can in longer duration bonds, while taking less interest rate and credit spread duration risk.

Corporates entering 2023 in a strong position:

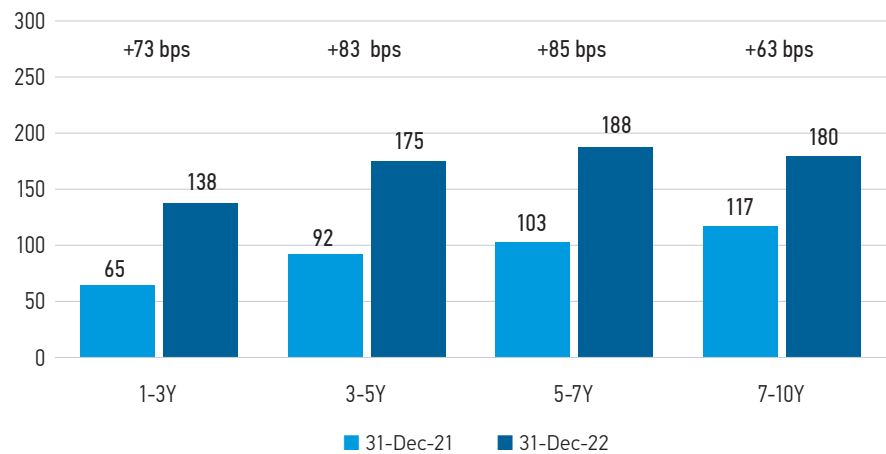
Corporates are entering 2023 from a strong position, with defensive business models, strong liquidity, optimised costs from the covid era, and leverage that recognises the risk to profitability in 2023. With employment remaining strong, consumer balance sheets supported by the fiscal stimulus under Covid and aggregate demand supported by the economic re-opening, 2023 is anticipated to be better than expected. We expect default rates to rise but not spike, as expected in a traditional recession. In fact, this recession looks “different” with nominal growth remaining strong and nominal wage growth positive.

**DISPLAY 5
German Government Bond Yields: 1 year change**



Source: Bloomberg, as at 31st December 2022. Past performance is no guarantee of future results

**DISPLAY 6
European Investment Grade Spreads: 1-year change**



Source: Bloomberg, as at 31st December 2022. Index refers to Bloomberg Euro Corporate Bond Index, broken down by tenors. The index is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results

Credit Valuation:

The widening of 1-3-year Euro investment grade credit spreads in 2022 reflects the widening of swap spreads as well as weaker credit markets. As shown in *Display 7*, 1-3-year credit spreads closed 2022 above their post financials crisis average.

Display 8 shows that a large part of that widening was driven by wider swap spreads. In Europe, wider swap spreads were primarily the result of a shortage of collateral, which caused German government bonds to trade expensive.

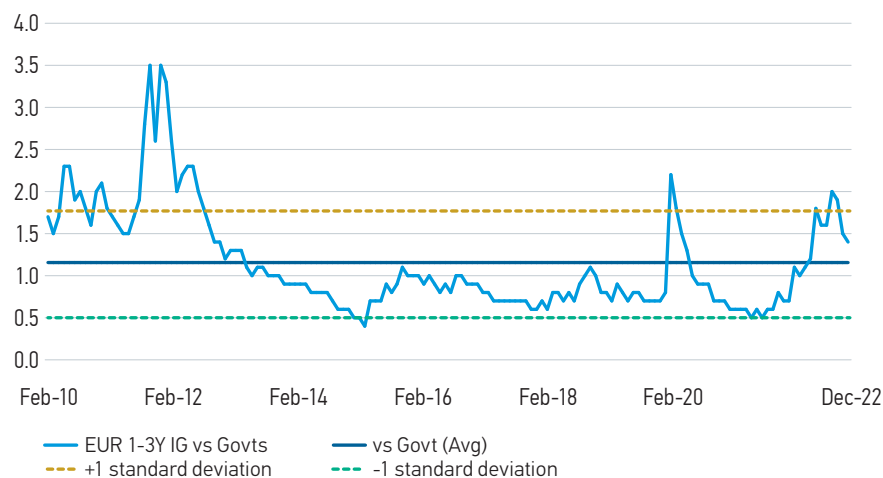
We expect credit spreads to remain range bound above long run average reflecting current macro uncertainties. Carry should be a driver of returns with government bond yields and credit spreads at attractive levels. We expect outperformance in 2023 to come in part from swap spread tightening, as the recent increase in the supply of short dated German government bonds, ECB tapering reinvestments in their Asset Purchase Programme and early repayment of Targeted Longer-term Refinancing Operations (TLTROs) payments by banks helps to alleviate the shortage of government bonds.

Summary

The speed and scale of rates hikes by the ECB in 2022 caused short duration government bond yields to move sharply higher. The threat that this could lead to a recession drove credit spreads wider. Coming into 2022, the low level of absolute yields meant that short duration investors had a lot of cushion against these moves.

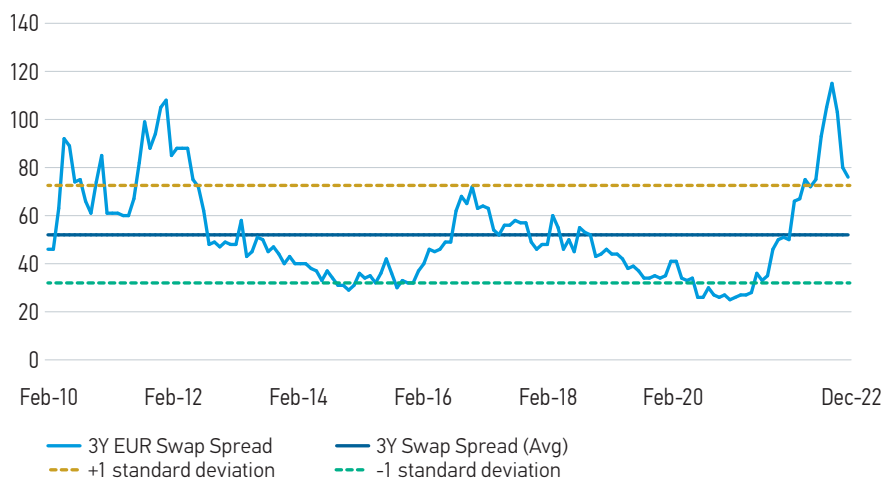
Going into 2023, inflation has started to trend lower, which should reduce interest rate uncertainty. Absolute yields are much higher and will help cushion the impact of further move higher in yields. Historically, higher

DISPLAY 7
EUR 1-3Y IG Index (Spread to Govt)



Source: Bloomberg, MSIM, as at 31st December 2022. Index refers to Bloomberg Euro Corporate Bond 1-3 Year Index. The index is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results**

DISPLAY 8
3Y EUR Swap Spreads



Source: Bloomberg, MSIM, as at 31st December 2022. **Past performance is no guarantee of future results**

yields have provided investors a much better starting point to generate positive absolute returns.

We believe short duration fixed income currently offers investors attractive

yields to help meet their goals without the need to extend duration and increase interest rate risk, or move down in credit quality and increase default risk.

Risk Considerations

Diversification neither assures a profit nor guarantees against loss in a declining market.

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DEFINITIONS

Basis point: One basis point = 0.01%.

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