Janus Henderson INVESTORS

SHORT-DURATION FIXED INCOME: *SAVE SHOULD NOT MEAN SACRIFICE*

Investment Insights Series

Portfolio Manager Nick Maroutsos believes that capital preservation and attractive risk-adjusted returns are not mutually exclusive despite zero-interest rate policy across much of the developed world.

While the global economy appears to have absorbed the worst of the blows thrown by the COVID-19 pandemic, several of the punches landed will leave lasting injuries. Entire segments of the economy have likely been permanently upended and many of the job losses in sectors like retail and travel are not coming back. Despite last year's rebound, some pockets of financial markets also continue to nurse wounds – and probably will for quite some time.

Acutely affected is the bond market. This was by design as fixed income securities were the primary mechanism global central banks relied upon in executing their strategy of hyper-accommodative monetary policy. The result has been a distortion that has compromised a fixed income allocation's historical proposition. Two central tenets of bond investing are capital preservation and a consistent income stream. With sovereign debt richly priced on the back of massive purchases by global central banks, the historical asymmetric risk of bonds – more room for prices to fall than to rise – has become even more perilous. Investors are not only faced with a higher likelihood of capital losses but also are not sufficiently compensated for this risk given miniscule yields, especially on shorter-dated securities.

A Hand on the Scales

Investors tend to approach shorter-dated bonds with either savings in mind or as a source of liquidity. The latter is often the objective of corporate treasuries with large cash positions. In either case, capital preservation is paramount. Investors recognize that an allocation to shorter-dated bonds means compromising returns for capital preservation. Compromise, however, is different from sacrifice, which is largely what markets are commanding at present.

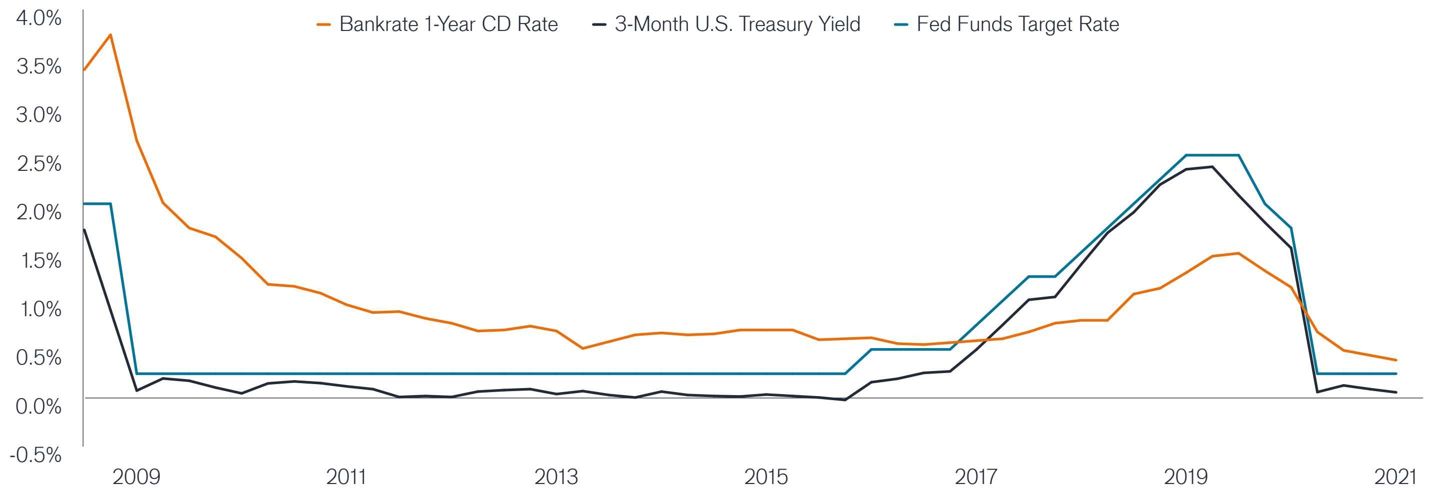
This phenomenon is nothing new. In the 10-year period ending in May 2008 – just as the Global Financial Crisis (GFC) was about to explode – the yield on the 2-year U.S. Treasury averaged roughly 3.9%. In the decade ending January 30, it averaged 0.92%. The same erosion of yields is on display in the 3-month Treasury Bill. Having averaged 3.41% prior to the GFC, it's managed to only eke out a 0.58% annual return over the past decade. Driving this was shorter-dated Treasuries anchored to a fed funds target rate of close to 0.0%.

Nick Maroutsos
Portfolio Manager

Key Takeaways

- With policy rates expected to remain low over the midterm, cautious investors can feel like they must sacrifice an acceptable return when allocating toward shorter-duration fixed income.
- We expect real returns on certificates of deposit and Treasury bills to remain negative as central banks keep their word in not increasing rates and the global economy's exit from the COVID-19 pandemic is more uneven than anticipated.
- Investors focused on capital preservation can still earn relatively attractive yields on shorter-duration securities by expanding their horizon to include developed markets with higher interest rates.

Exhibit 1: Short-Term Treasury Yields and Bank CD Rates Taking Cues from Low Policy Rates



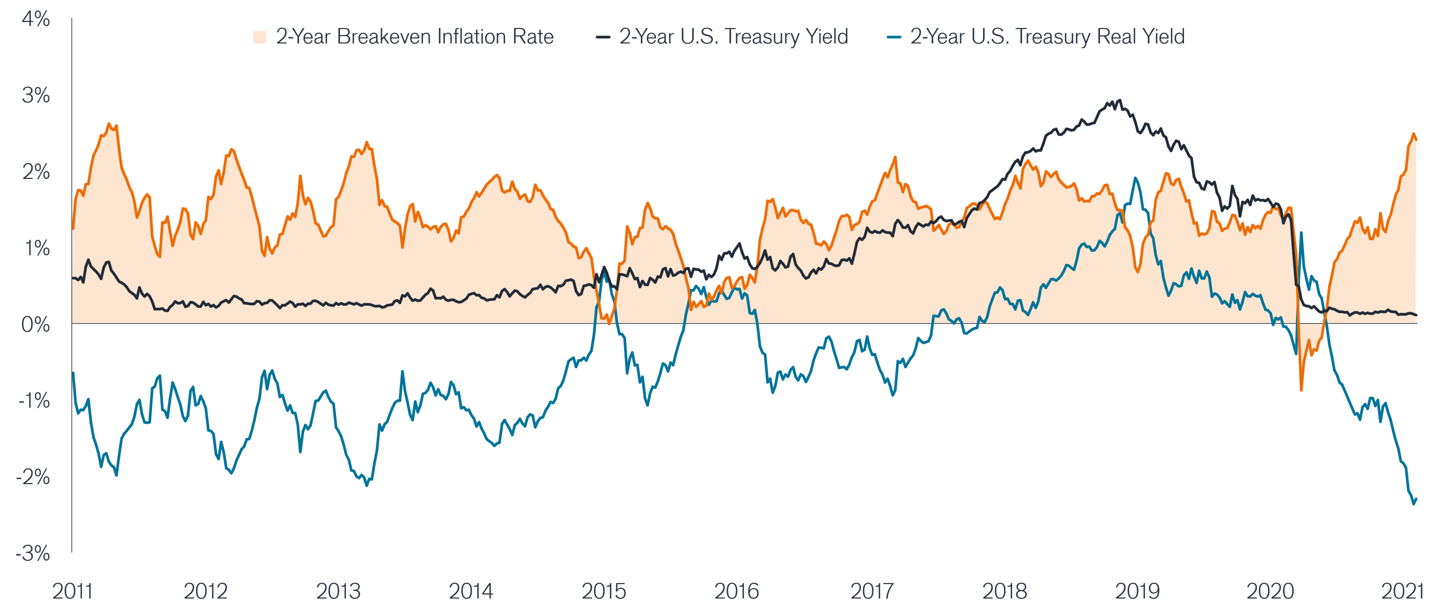
Source: Bloomberg, as of 31 December 2020. Past performance is no guarantee of future results. An investment in a CD may be insured by the federal government, an investment in securities is not.

Many savings-focused investors opt for bank certificates of deposit (CD) as an alternative to T-bills. While rates are locked in for periods such as 12 months, in an era of declining – or already rock-bottom – Treasury yields, rates on CDs tend to eventually converge toward those on T-bills, forcing one to reinvest at the prevailing lower rate.

Shorter-dated instruments tend to have low credit risk. Consequently, investors need only to capture a yield higher than the rate of inflation to lock in a positive real yield. Here is where it becomes evident just how punishing the past decade has been to savers. With inflation as measured by the Federal Reserve's (Fed) preferred gauge – the core Personal Consumption Expenditure Price Index – averaging 1.61% annually, real yields on shorter-dated Treasuries have been deep in negative territory for much of the post-GFC era.

The same holds true for real CD rates. Over the past decade, the real rate on 1-year CDs has averaged -0.83%, based on annual inflation less food and energy. Prior to the GFC, investors could count on CD real rates averaging 2.1% over the 10-year period ending in May 2008.

Exhibit 2: Real Yield on 2-Year U.S. Treasuries Deep in Negative Territory



Source: Bloomberg, as of 31 December 2020.

No End in Sight

If investors are hoping for a return to positive real yields on CDs and shorter-dated Treasuries, they are likely in for a long wait. Fed officials have stated they have no plans to raise their overnight policy rate – the one that guides short-term interest rates – at least well into 2023. We doubt that economic developments will provide any impetus to change course. While we are likely closer to the end of the pandemic than to its onset, the outlook for the global economy is far from certain. The vaccine rollout has been less than smooth, and the emergence of COVID-19 variants may prolong a return to normalcy. And once society eventually does exit from this crisis, we may find "normal" looks considerably different. Travel, tourism and retail – all major sources of employment – will continue to face headwinds for the foreseeable future. Lest we forget, prior to the pandemic, the global economy was already softening as countries grew cooler toward the concept of unfettered trade.

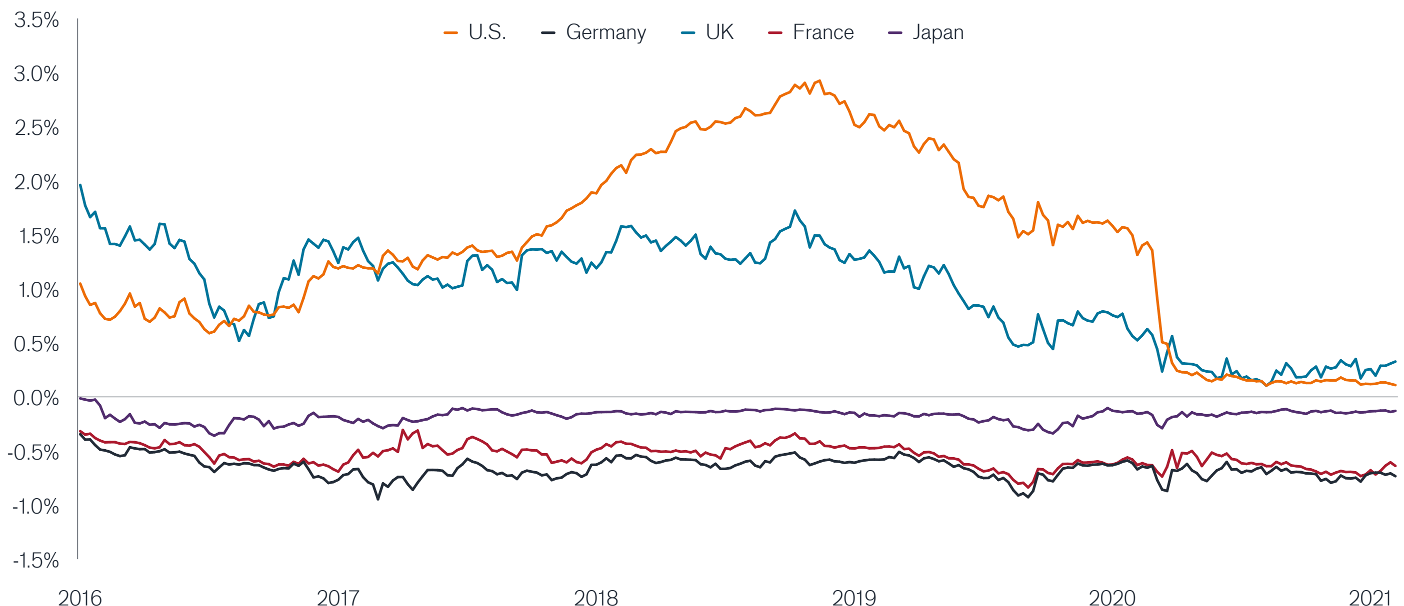
While investors likely won't receive any lifeline in the form of higher nominal rates, there is the risk that real yields could slip even further should inflation exceed expectations. Higher prices are not our baseline scenario, but with global central banks having created trillions of dollars in fiat currency in 2020 and fiscal accommodation also priming economies – a development that should accelerate under the Biden administration – core inflation could rise above its current level of 1.45%. Already, TIPS markets are pricing in headline inflation averaging more than 2% over the next five years. With the Fed likely holding firm on rate hikes, an uptick in inflation would add insult to injury for savers as real yields plunge deeper into negative territory.

Few Safe Harbors

There are plenty of reasons for concerned investors to maintain exposure to cash and cash-like securities. Consensus forecasts continue to call for a better-case emergence from the pandemic. We are not so sure. The global nature of this crisis means there are no asynchronous destinations for capital; nearly all regions are confronting the same difficulties. While Asia has managed the pandemic with more astuteness than have the U.S. and Europe, flagging demand in the latter two regions is likely to weigh on the prospects for Asian exporters.

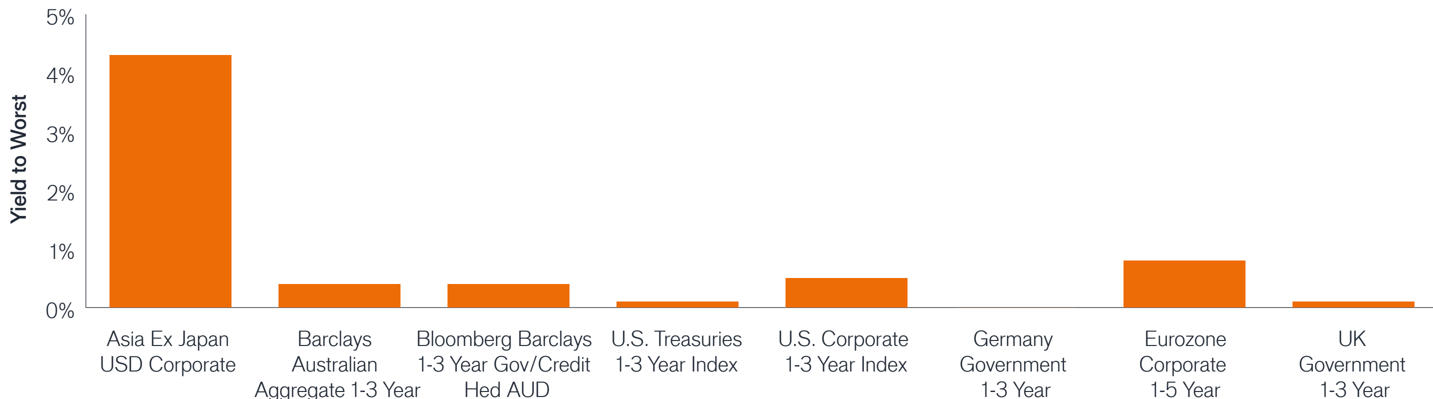
Punishing short-term rates are more tolerable when there are viable alternatives. But with riskier assets such as equities and corporate credits richly priced, we see few asset classes well positioned to appreciate over the near- to midterm. As markets recovered in dramatic fashion starting in March 2020, the biggest risk to investors was perhaps missing out on the historic gains in growth equities, followed by the rally in corporate credits. With valuations by many measures stretched and global growth uncertain, investors choosing to cash in some gains are faced with the grim math of paying for the privilege – in real terms – of maintaining a conservative allocation.

Exhibit 3: 2-Year Sovereign Rates in Developed Markets Remain Near Historic Lows



Source: Bloomberg, as of 31 December 2020.

Exhibit 4: Global Government and Corporate Credit Yields (USD Hedged)



Source: Bloomberg, as of 31 January 2021.
Yield to Worst is a measure of the lowest yield that can be received on a bond assuming, without defaulting, the bond is called at its earliest date.

Not Settling for Less

When looking at miniscule-to-negative short-term rates in the U.S., Europe and Japan, all may seem lost to investors in these jurisdictions who believe liquidity and capital preservation are prudent at this time. That, however, is not the case. To be sure, yields are low across the world. Yet many high-quality fixed income securities are available that still offer attractive yields without having to take on unwelcome levels of interest rate or credit risk.

Identifying these involves expanding one's investment universe to include developed countries with higher growth trajectories and commensurately higher policy rates. Many of these are in the Asia ex Japan region. In addition to more attractively yielding government debt, this region is home to many quasi-sovereign and corporate issuers in strategically important sectors that have implicit government backing. Among these are energy, infrastructure and banking.

Corporate credits in developed Asia, Australia, New Zealand and Canada also can offer higher yields on similarly rated U.S. issuers. This includes U.S. corporations that choose to issue debt in multiple jurisdictions. While some such issuance is U.S.-dollar denominated, local currency issuance can be hedged back to dollars, thus lowering currency risk. Given global interest rate differentials, at present hedging back to dollars actually stands to increase returns.

Keeping Positive – Creatively

With 2020's near double-digit bond market returns as measured by the Bloomberg Barclays Global Aggregate Bond Index likely not repeatable, many investors may decide the time is right for increasing their allocation shorter-duration instruments like T-bills and CDs. Holding them back, however, is the fear of incurring negative real returns thanks to persistently accommodative monetary policy. We don't believe the guiding hand of central banks should be the deciding factor in portfolio allocation. By geographically expanding one's universe of high-quality, short-duration securities, bond investors can favor capital preservation without sacrificing positive real returns. While the solution may not be as basic as purchasing a CD from the local bank, the inclusion of global issuance can help a portfolio replicate the traditional fixed income characteristics of capital preservation and income generation.

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Fixed income securities are subject to interest rate, inflation, credit and default risk. As interest rates rise, bond prices usually fall, and vice versa. Foreign securities, including sovereign debt, are subject to currency fluctuations, political and economic uncertainty and increased volatility and lower liquidity, all of which are magnified in emerging markets.

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FOR MORE INFORMATION CONTACT JANUS HENDERSON INVESTORS
151 Detroit Street, Denver, CO 80206 | www.janushenderson.com

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