Compelling Risk/ Return Profile in Short-Duration Credit

Short-duration corporates are attractive as the economy slows.

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KEY INSIGHTS

- Short-duration investment-grade credit presents an attractive risk/return profile with the current economic expansion now the longest in U.S. history.
- Key indicators we track to gauge the health of investment-grade corporate issuers are flashing warning signs, implying that the credit cycle is clearly aging.
- We favor short-duration investment-grade credit for its defensive properties—limiting credit risk if the economy weakens—and attractive incremental yield.

With the current economic expansion now the longest in U.S. history, an allocation to a short-duration[1] fixed income credit portfolio is a tactical way to gain incremental yield while limiting downside risk if the economy tilts toward recession. Several key indicators we track to measure the health of investment-grade corporate bond issuers are flashing warning signs, which implies that the credit cycle is clearly aging. However, these indicators do not yet indicate that a recession is on the near-term horizon. In this environment, short-duration investment-grade credit presents an attractive risk/return profile.

Credit Fundamentals Show Slowing Economy

We monitor five fundamental credit indicators to gauge the health of investment-grade corporate issuers and the broad economy: earnings; earnings before interest, taxes, depreciation, and amortization (EBITDA); operating profit margins; earnings growth rate; and sales. Our analysis of the data preceding recessions going back to the 1980s shows that the first four indicators reliably turn negative before a recession. Sales is a less reliable indicator, as sales declined before only 50% of historical recessions.

The latest data show that all five indicators are declining, reinforcing our view that the economy is weakening and that the current credit cycle is nearing its end. However, only the earnings growth rate and operating margins are falling as quickly as they have before past recessions. This leads us to conclude that the economy is fragile and vulnerable to shocks, but a recession does not appear to be imminent. Looking forward,

[1] Duration measures a bond's sensitivity to changes in interest rates.

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we anticipate that the U.S.-China trade dispute will continue into 2020 and be the most important driver of global growth. On the positive side, the Federal Reserve's recent rate cuts should help support the economy, at least partially offsetting the drag from trade concerns.

Attractive Risk/Return Profile for Short-Duration Corporates

In this slow-growth, late-cycle environment, shorter-duration credit presents an attractive trade-off between risk and potential return. Short-maturity positions offer less sensitivity to widening credit spreads[2] if the economy meaningfully deteriorates and the fundamental condition of corporate issuers worsens. At the same time, investment-grade credit exposure provides a noticeable yield advantage over Treasuries and other lower-risk segments.

Our analysis of return and risk data since early 2004 demonstrates that short-duration investment-grade corporates have historically generated stronger risk-adjusted returns than longer-duration credit. Plotting excess return[3] against volatility of excess returns shows that the one- to three-year segment of investment-grade credit has provided superior risk-adjusted returns, with the longest-duration corporates generating weaker performance relative to risk. This trend exists across the range of investment-grade credit ratings. The strong performance of the one- to three-year segment results from its combination of lower sensitivity to changes in credit spreads and still-compelling yield.

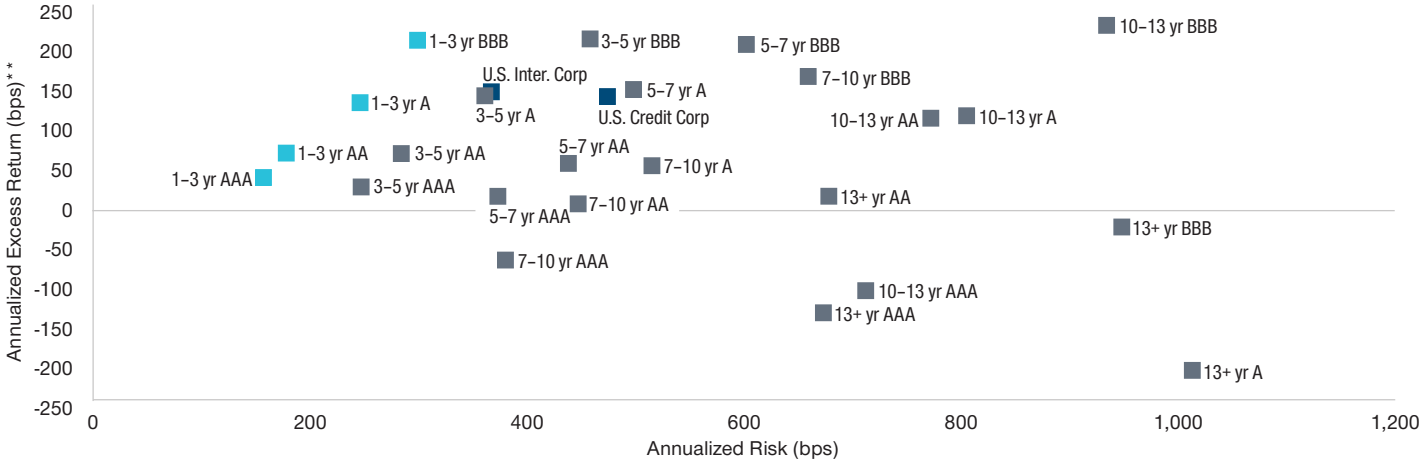
Shorter-Than-Usual Duration Positioning

Within the investment-grade corporate debt exposure in our low-duration

(Fig. 1) Short Credit: Strong Risk-Adjusted Return

Excess return versus risk,* February 2004–September 2019

As of September 30, 2019



Past performance is not a reliable indicator of future performance.

Light blue represents short-duration segments, grey represents intermediate- and long-duration segments, and dark blue represents broader indices

Source: T. Rowe Price analysis of Bloomberg Barclays U.S. Corporate Bond Index. Bloomberg Index Services Ltd. (See Additional Disclosure.)

* Annualized volatility (measured by standard deviation) of excess monthly returns.

**A basis point (bp) is 0.01 percentage points.

[2] Credit spreads measure the additional yield that investors demand to hold a bond with credit risk relative to a comparable-maturity Treasury security.

[3] Return above that of a comparable-maturity Treasury security.

funds, we've been keeping duration even shorter than usual to reflect our view of the fragile U.S. economy and the late stage of the credit cycle. While the economy and corporate fundamentals could improve, boosting prices of longer-duration corporate bonds more than short-maturity positions, we are confident that our short-duration stance is an appropriate strategy to improve risk-adjusted returns.

From a broader point of view, we believe that investors should have an allocation to short-duration investment-grade credit for its combination of defensive properties—limiting credit risk if the economy weakens—and attractive incremental yield.

WHAT WE'RE WATCHING NEXT

Investor perceptions on the outlook for the U.S.-China trade conflict has been driving sentiment toward riskier asset classes, including investment-grade corporate bonds. Although we do not believe that the countries will reach an agreement to settle the dispute in the near term, we will continue to monitor progress in negotiations.

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