Long-Dated Credit Can Boost Returns in a Tightening Environment

Shorter-dated bonds are typically hit harder by rising inflation and low growth.

March 2022

Kenneth Orchard
Portfolio Manager

Onur Uncu
Quantitative Analyst

Russia's invasion of Ukraine has injected a heavy dose of uncertainty into the global economic outlook, but this month the U.S. Federal Reserve stuck to its plan to raise interest rates for the first time since 2018. Given the likely inflationary impact of the war, the Fed looks set to continue on its tightening path for the remainder of the year. For investors, then, the challenge of how to position their portfolios for a rising rate environment remains a pressing one.

The Fed's determination to tighten financial conditions is hardly surprising. Stubborn inflationary trends caused by post-pandemic easy monetary policy, supply chain disruptions, and rising energy prices have been a source of anxiety in markets for some time. Looming inflation puts pressure on central banks to tighten policy, which causes trouble for credit investors in two ways: first, rising bond yields have typically hit corporate bonds hard because of the duration[1] embedded within them; and second, corporate bond spreads[2] tend to be adversely affected by tighter financial conditions. In this article, we'll focus on the latter.

Higher policy rates generally make corporate borrowing more expensive as investors demand a premium over the policy rate when they lend to corporates. Rising borrowing costs eat into corporate profits, which is negative for corporate bond spreads.

Not all corporate bonds are equal, though. Monetary policy tends to normalize in the long term as growth slows and/or inflation subsides. Aware of this, the markets tend to price in the fact that shorter-term bonds will be heavily exposed to short-term risks while longer-dated bonds will likely benefit from a normalization of conditions. This is evidenced by the fact that, historically, the Sharpe ratios (a measure of risk-adjusted returns) of longer-dated U.S. investment-grade (IG) corporate bonds have been higher than shorter-dated IG

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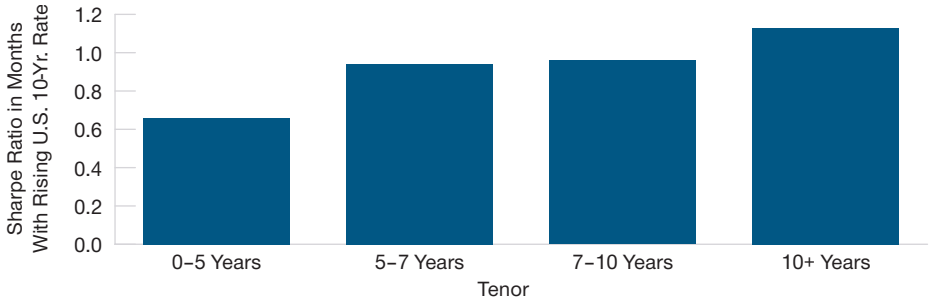
[1] Duration measures a bond's sensitivity to changes in interest rates.
[2] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

Longer-Dated U.S. IG Credit Has Outperformed During Periods of Rising Yields

(Fig. 1) Markets have typically priced in the normalization of policy in the long term



As of February 28, 2022.
Past performance is not a reliable indicator of future performance.
Based on monthly credit excess returns data between January 2000 and February 2022.
We took monthly excess credit returns for each of the four tenors (maturity ranges) above. For each month, we also calculated the change in the U.S. 10-year treasury rate. We then took the subset of the months where the U.S. 10-year rate had gone up. In that subset, we calculated the annualized excess returns and volatility for each tenor. The Sharpe ratio is calculated as the ratio of average annualized excess returns divided by average annualized excess return volatility.
Sources: Bloomberg Indices, Bloomberg Finance L.P.

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> *Quantitative Analyst*

bonds when yields rose (Figure 1). This suggests that credit investors may be able to boost performance in the period ahead by potentially allocating more to longer-dated credit.

It's worth noting that the current tightening conditions differ from previous ones in a way that spells more risk for corporate bond spreads. Over the past 40 years, the Fed's main goal with tightening has been to slow growth and prevent economic overheating; this time, it is trying to control inflation. This means that unless inflation falls back, the Fed is likely to continue tightening, even if growth is weaker than during previous tightening periods, which would hit shorter-term credit harder than longer-dated credit. An extended war in Ukraine could exacerbate this still further given that wars are invariably inflationary.

Positioning at the long end of the credit curve should have the additional benefit of being cash-efficient. Long-dated bonds tend to have higher "duration times spread" (a measure of the credit volatility of a corporate bond) per dollar invested. This means that a target risk level may be achieved with a smaller cash outlay. Allocating to longer-dated corporate bonds, therefore, potentially allows investors to unlock cash that may then be used in other ways to generate yields, such as purchasing Treasury inflation protected securities (TIPS).

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ID0004919 (03/2022)
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